PREM 19/174

PART 7

SECRET

Confidential Filing

Economic Strategy

Pay and Prices monthly Economic Report.

The Economic Prospect.

New Earnings Survey 1980.

Economic Policy

Part 1 May 79

Part 7 Sept. 80.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~16-9-80.~~		~~26.11.80~~					
~~[illegible]~~		~~15.12.80~~					
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~~24.11.80~~							

PART 7 ends:-

Ch of Exch 31.12.80

~~CAW to Walters 30.12.80~~

PART 8 begins:-

E(81)1 2.1.81

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(80) 108	30/09/80
E(80) 126	03/11/80
E(80) 140	01/12/80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed D Wayland Date 4 March 2010

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Treasury and Civil Service Committee,
2nd Report, Session 1980-81: The
Government's Economic Policy: Autumn
Review.
Published by HMSO, 15 December 1980

Signed AWayland Date 4 March 2010

PREM Records Team

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Prime Minister
The Chancellor has sent copies of this to John Hoskyns and Sir Keith.

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

PRIME MINISTER

31/12

GOVERNMENT STRATEGY

It may be useful to let you have my post-holiday-thinking reaction to John Hoskyns' gloomy, but not unhelpful, minute of 22 December. I found it useful to read it alongside the note which Ray Whitney brought back from USA, entitled "Avoiding a GOP economic Dunkirk": you will be disconcerted, as I was, to find the transatlantic commentators referring to "Thatcherisation" as a condition to be avoided, if possible!

2. That is too gloomy a view. So is John Hoskyns - I suspect almost deliberately, and perhaps rightly - with his piece of provocative pessimism. Personally, I am sure we are <u>not</u> off track: but we are less well on track - and less far down the track - than either of us would have wanted. It is no good reacting (as John Hoskyns half invites us to do) by protesting that "we shouldn't be starting from here". We <u>have</u> started; and we're <u>not</u> still "here", we <u>are</u> part of the way towards "there": the question now is how to move further, and faster, in that direction.

3. The problem has various components. Industrially and economically we are a relatively backward nation, and becoming more so. (I am tempted to protest by pointing to "the good bits": but I remember <u>your</u> sense of shock at discovering that <u>Belgium</u> plans to sell more steel next year than BSC, etc. etc.) This backwardness is

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barely realised; and then only by a minority. Those who do realise would like to think it was possible to get things right. From time to time, they try to do so. Not hard enough, not long enough. Because life's still quite comfortable, really. And most people have got used to "lack of success" (more comfortable than "failure"). So "let's try, by all means: but always keep our options open" - and end up (as the American document says) with "parochial fire-fighting as usual, in response to constituency distress".

4. Those are the weaknesses. But there is a strength. And that, basically, is the Thatcher factor. People do have a sense that this Government - more particularly you - does see some of these things, and is possessed of a tenacity, which might just work, if only its sustained. After all it does seem to have worked, after a fashion which is unusual for Britain in recent decades, in Rhodesia, the EEC - even Ulster. But people are slightly scared, many of them, because we haven't convinced enough of them that we know what we're doing, and that we're totally confident of reaching our destination - which anyway is a long way away. And more than a few people think we're quite mad! Yet very few are able or willing to proffer an alternative analysis of Britains problems, let alone a coherent alternative solution. So we still have a lot more support than we might have expected. And even the sceptics would like to see us doing well.

5. So we do have to renew and strengthen our thrust, and give it greater coherence - by doing two things:

(a) Ensuring that we concentrate the maximum of talent on the fight for a relatively limited number of objectives;

(b) Consciously planning to broaden the base of committed and active support for the difficult things that will have to be done in pursuit of those limited objectives.

I stress point (b); we cannot take too much trouble over carrying with us those who should be on natural allies - in the city, the civil service and industry, as well as in politics: they want to see us succeed, to see any Government succeed, after so much disappointment.

6. If I was asked to have a first shot at identifying the key issues, the limited objectives, (and I do not differ much from John Hoskyns' section 4.3), I should pick the following:

(a) The whole business of reducing inflationary expectations, the indexation mentality, the cost-plus society;

(b) The removal of those factors - throughout the public sector - which in the American sentence, have made "the federal budget ... an automatic 'coast-to-coast soup line' that dispenses remedial aid with almost reckless abandon;

(c) The further, substantial, curtailment of the impossible power of "organised" labour - alongside a major extention to employee involvement.

(d) A major change in the relative status, rewards and security of innovators, enterpreneurs, risk-takers on the one hand and of coasting, competent, comfortable survivors on the other.

7. And if I was asked to advise how - differently from what's happened so far - to develop our approach towards these problems, then certainly I should not differ greatly from John Hoskyns. I suggest these stages:

(a) The half-day discussion proposed in John Hoskyns paragraph 6.5.1; I could suggest names; some compact papers would be desirable.

(b) An exercise - perhaps another larger group discussion, perhaps a series of bilaterals, perhaps both - in which you should secure the commitment of all key colleagues to a limited programme, along the lines discussed above.

(c) The execution of the measures proposed - possibly through, or with the help of, a small group of task-forces, comprising outsiders as well as Minister, civil servants. (I am less certain than John Hoskyns about these. If we did go along those lines, then these task-forces should be designed almost as much to maximize support for what was going on as to get it done.)

8. We still face formidable tasks. We have made a start - but only a start. To carry things through to the next stage, we need a considered plan - and soon. The hopes of very many people are still with us.

9. I am copying this minute to Keith Joseph and John Hoskyns.

DWiggins

for (G.H.)

31 December 1980

(Prepared by the Chancellor & signed in his absence)

ECON POL

MR WALTERS (on arrival)

I imagine that fairly soon after your arrival here you will want to call upon a number of Ministers and senior officials in the economic field. You will, of course, already have your own ideas about who these should be, but in case it is of any help, you may like to think about including some or all of the following in your round of calls:-

Treasury
Chancellor of the Exchequer: Chief Secretary;
Financial Secretary to the Treasury; Sir Douglas Wass;
Mr. Terry Burns; Sir Anthony Rawlinson; Sir Ken Couzens;
Mr. Bill Ryrie; Mr. Peter Middleton; Mr. Adam Ridley.

Bank of England
The Governor

Department of Industry
Secretary of State for Industry; Sir Peter Carey;
Mr. David Young.

Department of Trade
Secretary of State for Trade

Cabinet Office
Sir Robert Armstrong; Mr. Robin Ibbs

I realise that this is a fairly lengthy list, the more so as there will be people outside Government whom you will also wish to see, and it might be possible for you to combine some of the meetings, eg you might see whether Sir Douglas Wass would like to have some of his Treasury colleagues with him when he sees you.

M.A. WHITMORE

30 December 1980

SECRET

Mr Lankester

22 December 1980
Policy Unit

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PRIME MINISTER

GOVERNMENT STRATEGY

As promised, I attach a paper reviewing Government strategy to date.

I am copying this minute and the paper to Geoffrey Howe and Keith Joseph.

JH

JOHN HOSKYNS

SECRET

SECRET

10 DOWNING STREET

19 December 1980

Robin Ibbs Esq
CPRS
Cabinet Office
70 Whitehall
LONDON SW1

Dear Robin,

I attach a copy of a revised version of our Strategy Paper which we discussed in the Autumn. We have managed to cut its length by about a third and made some more specific proposals at the end of the paper.

It is going to the Prime Minister, the Chancellor and Sir Keith Joseph on Monday, 22 December.

I am copying this letter and the report to Derek Rayner, Terry Burns, Peter Cropper, David Wolfson, David Young, Peter Middleton and Alan Walters.

Yours ever

John

JOHN HOSKYNS

SECRET

18 December 1980
Policy Unit

GOVERNMENT STRATEGY: PAPER NUMBER 3

1. INTRODUCTION

1.1 This paper reviews progress with the Government's central strategy, noting the main lessons learned to date.

1.2 In summary, the Government has barely started to address the strategic problems facing it. Its performance may appear better than its predecessors, in terms of realism and determination. But against the task* it was elected to perform, its performance is inadequate. It will therefore begin to look no different from its predecessors; and will thus be judged on traditional criteria (prices and living standards) unless its perceived competence improves and its strategy is understood.

1.3 This is difficult, because the Government does not yet have a coherent and adequate strategy, nor has it organised itself to implement a strategy if it had one.

1.4 This is the point at which Ministers and Governments under great pressure can lose touch with reality, eventually hearing only favourable reports and discounting the rest. On Weinstock's dictum, "Lack of frankness is the great management offence"; this paper tries to prevent that happening. If our thinking turns out to be over-pessimistic, then nothing is lost. Certainly, pessimism (ie too much realism) has never been Britain's problem in the past.

1.5 The structure of the paper is as follows:

* NB. We are talking about economic strategy, not about defence or foreign affairs.

2 HOW ARE WE DOING?

2.1 We are still shooting behind an accelerating target

2.1.1 Our failure has been under-kill, not (as our critics suggest) over-kill. This all stems from the massive underestimate of the size of the problem, which has persisted from 1978 in Opposition, right through into Office. The main result has been the lopsided Keynesian squeeze on the private sector.

2.1.2 Present problems - money supply, public spending, PSBR, MLR - are all part of our failure to stabilise. This stems in turn from a failure to organise for the key tasks. The muddle over firemen's pay stems from our reluctance to set up a task force after E on 23 July, to ensure we did as well as possible on public service pay settlements.

2.1.3 Despite a year's warning, colleagues never reached the point of understanding the difference between Transition (deceleration of money GDP) and real cuts as per PEWP. The result was a token de-indexation, giving maximum political odium and minimum PSBR impact. The simple insights about Transition and Stable State and thus the meaning of de-indexation could all have been reached by coffee break on the first morning of any sensibly run teach-in.

2.1.4 The decline in inflation, the apparent change of attitudes and the level of exports are all deceptive; symptoms of recession, private sector squeeze and a high pound. Private sector management probably <u>has</u> recovered some confidence for good. Workforce attitudes in smaller and non-unionised companies may well have changed profoundly. Union <u>behaviour</u> in large private sector firms has changed, but probably not the underlying attitudes. There is less sign of change in the public sector. The old wage pressures are likely to emerge when the upturn comes. Indeed, a trade union leader recently promised Jim Prior that they "would get their own back" when the recession was over.

2.1.5 In short, we have been brutal to our friends - employers, small businesses, the private sector; and gentle with the real problems - trade unions, nationalised industries, lame ducks, public services pay.

(2. HOW ARE WE DOING? cont.)

2.2 North Sea oil is the Joker

2.2.1 North Sea oil is the principal mitigating factor. The increase in oil prices has led to unprecedented recession and rapid appreciation of the pound, putting adjustment strains on the private sector which are not yet widely understood.

2.2.2 The view seems to be growing that oil prices and the pound will stay high and that many sound companies which could adjust given the time, will be destroyed before they can do so.

2.3 The "crisis of belief" is here

2.3.1 The "crisis of belief", predicted in our paper of 19 June on the Pay Round Debate, has now started. There are growing doubts among our most loyal supporters about both the resolution and the competence of this Government. There is a growing concern that it is a Government of strong words but inadequate action.

2.3.2 Loss of confidence and morale is infectious, both inside and outside Government. People stop trying - and this will include Ministers, civil servants, back-benchers - if they sense that the Government has lost its sense of direction. There is a danger that we move into the "recrimination phase", familiar in business, where everyone starts to blame everyone else. Muddle leads to demoralisation and poor performance; leading in turn to further muddle.

2.4 We can still get back on track

2.4.1 We have about six months in which to get back on track. This does not mean getting back onto the MTFS in number terms, but rather in terms of regaining control of events, ending dissension in Cabinet, and thus convincing the public that we know what we're doing and where we're going. Leave it much later, and we are getting close to the next Election. Key landmarks will be the Budget, PEWP, trade union reform, BSC decisions. As we said in our first Strategy Paper of 12 June 1979, "If we fail to achieve Stabilisation, as our

(2. HOW ARE WE DOING? cont.)

first objective, we can forget the rest. We will simply be on the run till we're chucked out". Despite Labour's disarray, there are many Tory supporters who are beginning to think that we may be on the run, defeated, like previous Governments, by problems which are just too big for us.

2.4.2 We believe it is quite possible to reverse this situation provided we set about it in the right way. But it will not happen by luck; or by making speeches; or by writing papers; or by conventional Cabinet and committee meetings. Nor will determination be enough. The main reason why Governments fail is that they never ask themselves the question "Why do Governments fail?" Understanding the answer to this question is the first step to success.

3. WHY DO GOVERNMENTS FAIL?

3.1 "The Art of the Possible" is not enough

3.1.1 Previous Governments have failed because they practise the politicians' conventional wisdom - the art of the possible. If the only thing that appears to be "politically possible" is failure, they fail. Britain's post-war decline has been caused - or certainly accelerated - by politicians who have never understood what is economically <u>necessary</u>, only what appears to be "possible".

3.1.2 All problem-solving must be tackled within <u>constraints</u>. Some of those constraints are recognised, some are simply taken for granted without question. Big problems are only solved when someone has the imagination and the nerve to break enough of those constraints. Few people seem to understand this.

3.1.3 <u>Strategy</u> is about breaking constraints. <u>Tactics</u> is about operating within them. Without a strategy for breaking constraints, Government finds itself constantly boxed in by constraints which it lacked the foresight to break, so that it simply cannot do what it <u>knows</u> must be done. We are boxed in today because we have been playing noughts and crosses in a game which demands Grand Master chess, for which the opening moves should have been designed in about 1978 during Policy Search (which was unfortunately a waste of time because the central problem, pay determination, was being handled by another group).

3.2 <u>We had already boxed ourselves in before the General Election</u>

3.2.1 This Government started with three central tasks: the control of public spending, the reduction of the PSBR and the deceleration of monetary growth. By the time we took office, we had already accepted four constraints which stopped us achieving those tasks. We were committed to Clegg and comparability; we had promised tax cuts; and we were pledged to maintain full indexing of social security. In addition, there was a time delay before any new trade union legislation could be effective. We were thus in a "policy box" before we began:

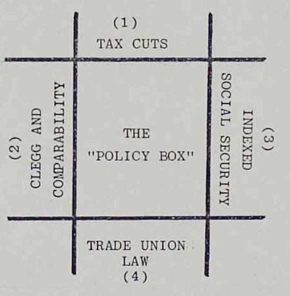

FIGURE 1

3.2.2 We created this box because it "wasn't politically possible" to do anything else. We did not, during 1978-9, have the type of strategic discussion which might have led us to a different conclusion; although, in our paper of 8 November 1978, we did present the likely outcome of different combinations of trade union law and bargaining systems, the aim being to work towards the bottom right-hand box in which a tighter legal framework, together with monetary and fiscal discipline and greater involvement of employees in the wealth-creating process would start a fundamental change of direction:

UNION POLICY / PAY POLICY	Union Status Quo= 'Militants Charter'	Balanced Bargaining Power = 'Moderates Charter'
Monetary and fiscal Discipline + Traditional Collective Bargaining	Economic disintegration	Greater stability but unchanged economic attitudes
Monetary and fiscal Discipline + Ouput-Related Bargaining (ORB)	Union Activists wreck ORB. Therefore	Stability + incentives = <u>New Attitudes</u>

This is what we asked for - & what we got.

<u>FIGURE 2</u>

3.2.3 Given these constraints, something had to give. Since it was not the constraints, it had to be the strategy. It was because we could see no solution inside the box that we suggested that a freeze - whether partially-indexed or total, whether in the whole economy or in the public services only - should be at least <u>considered</u> (our paper of 12 June 1979) as one possible way (discussion might have thrown up others) of breaking constraints (2) and (3), and thus reducing inflation with less damage to the economy.

3.3 A proper strategy is still not enough

3.3.1 Even if we had developed on paper a strategy which broke enough constraints to make our job possible, it is unlikely that we would have been (or will in future be) able to implement it.

3.3.2 This is because the machinery of Government is not suited to achieving change. It is not naturally innovative nor, in organisational terms, is it "task-orientated". There seems to be no systematic process for learning from past mistakes (we saw this as the machine started to tackle the IT project in a conventional way, which was doomed to fail). It lacks the skills, structure - and also the confidence bred by successful achievement. It is imbued with a deep conviction that nothing will really change and that the problems are not really soluble. In our view, this is as much the fault of politicians in past Governments as it is the fault of the Civil Service. The media are also part of this problem.

3.3.3 One thing is certain. There is no possibility of real change in society and in public attitudes - and thus in either economic performance or social behaviour - when the citizen's comment on Whitehall and Westminster is "Plus ça change . . ." We comment further on this problem in Section 5.2 below.

4. THE CABINET STILL DOESN'T UNDERSTAND THE PROBLEM

4.1 There are three inter-related problems:

(1) A short-term Stabilisation problem - summed up in the words "You can't get there from here"; needing turn-around measures.

(2) A North Sea oil/exchange rate problem - forcing on the economy a much faster adjustment than anyone had expected or than some fundamentally viable parts of the private sector may be able to stand; perhaps needing greater fiscal switch.

(3) A long-term problem of secular decline - the multi-causal historical/cultural decline of the UK economy, aggravated by a failure of elementary housekeeping by post-war Governments; needing comprehensive array of "Accelerators" and radical reforms.

Before the Election, we recognised - though rather superficially - Problems (1) and (3). Problem (2) is a more recent arrival which makes the first Problem, Stabilisation, much more difficult.

4.2 What does Stabilisation really mean?

4.2.1 In our first paper, "Government Strategy" of 12 June 1979, we suggested that Stabilisation was the main task for the first five years. Unless that was achieved, lasting economic recovery would be impossible " . . . like trying to pitch a tent in the middle of a landslide".

4.2.2 We argued that Stabilisation was a massively complex job, requiring the achievement of three inter-related objectives: ending inflation, by monetary policy; rational pay bargaining, by trade union reform and employee involvement; control of Government spending. We suggested that these were the three necessary, but not sufficient, conditions for stability and that they would take a full five years to achieve; and that our communications would therefore have to change, at the electoral margin, the criteria by which our performance was evaluated by the voters. We represented them as a simple diagram (see Figure 3 overleaf).

4.2.3 Stabilisation is crucial but difficult for a simple reason. The institutional structure of the economy makes it inherently unstable. This in turn has made the task of successive Governments impossible. Each Government has arrived pledged to rebuild the economic structure only to find that the structure is, as it were, on fire. It is not possible to commence renovation until the fire has been put out. But putting the fire out itself has turned out to be impossible because of

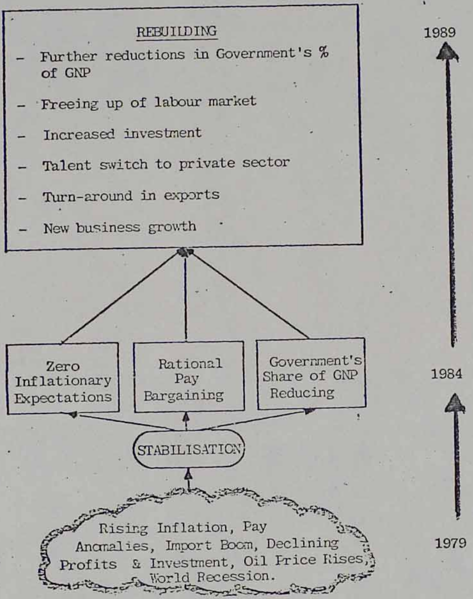
REBUILDING
- Further reductions in Government's % of GNP
- Freeing up of labour market
- Increased investment
- Talent switch to private sector
- Turn-around in exports
- New business growth
Zero Inflationary Expectations
Rational Pay Bargaining
Government's Share of GNP Reducing
STABILISATION
Rising Inflation, Pay Anomalies, Import Boom, Declining Profits & Investment, Oil Price Rises, World Recession.
1989
1984
1979

FIGURE 3

its ability to fan its own flames. Whatever analogy you like to use - whether fire-fighting, turn-around, "getting from here to there" - it is this first phase which has defeated every Government since 1964. So far, it is defeating us. It is the high pound which is bringing down inflation, not our policies. The accompanying recession is not a sustainable long-term solution.

4.2.4 The structure of the instability problem can be presented as follows:

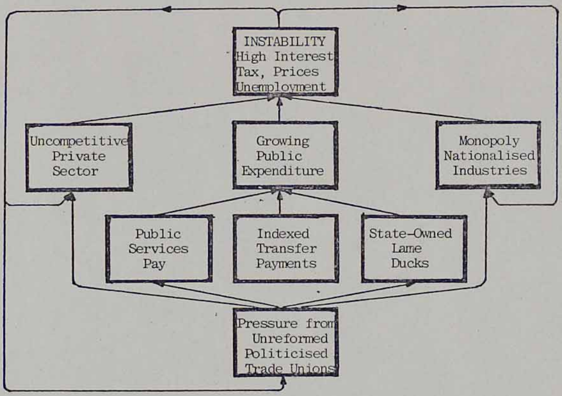

FIGURE 4

It is the interaction between the components of this system which gives the whole process its power and momentum. As a result, it makes mincemeat of successive Governments' economic policies. With this central instability, the UK economy simply cannot function properly. In bad times (recession or an external shock like OPEC) it starts to fall apart. In good times, it continues to drop slowly out of the Western industrial world. The system must be redesigned if recovery is to be possible. Improved methods of monetary control are only a small part of the answer, though no doubt an essential one.

4.2.5 Because colleagues never understood this basic problem, it has not been possible to develop a strategy for solving it. The MTFS was not a strategy, but an indispensable public statement of objectives. There was never an explicit programme of action to show how we were going to make MTFS happen, in terms of public services pay, and thus public spending, thus the PSBR. As long as that was (and is) the case, arguments about the best mechanism for monetary control will remain fairly academic. Once spending and borrowing are down, then it will still be important to get the best possible system of monetary control.

4.2.6 In the light of our experience over the past 18 months, we can now break the three Stabilisation objectives, shown in Figure 3 on page 9, into a more comprehensive and structured programme. (See Figure 5 overleaf.) But it is still important to remember that achieving all the tasks on this "Christmas tree" does no more than establish the foundations for recovery. At most, it changes the UK economy from one which can't recover to one which, given other actions, just might.

4.3 Long-term recovery

4.3.1 If we had developed a proper strategy for Stabilisation and were now on target with the MTFS (adjusted to reflect the bottom of the trade cycle) we would now be able to shift our attention to the medium term. For example:

- The need for a substantial and self-sustaining shift from pay/spending to profits/investment.

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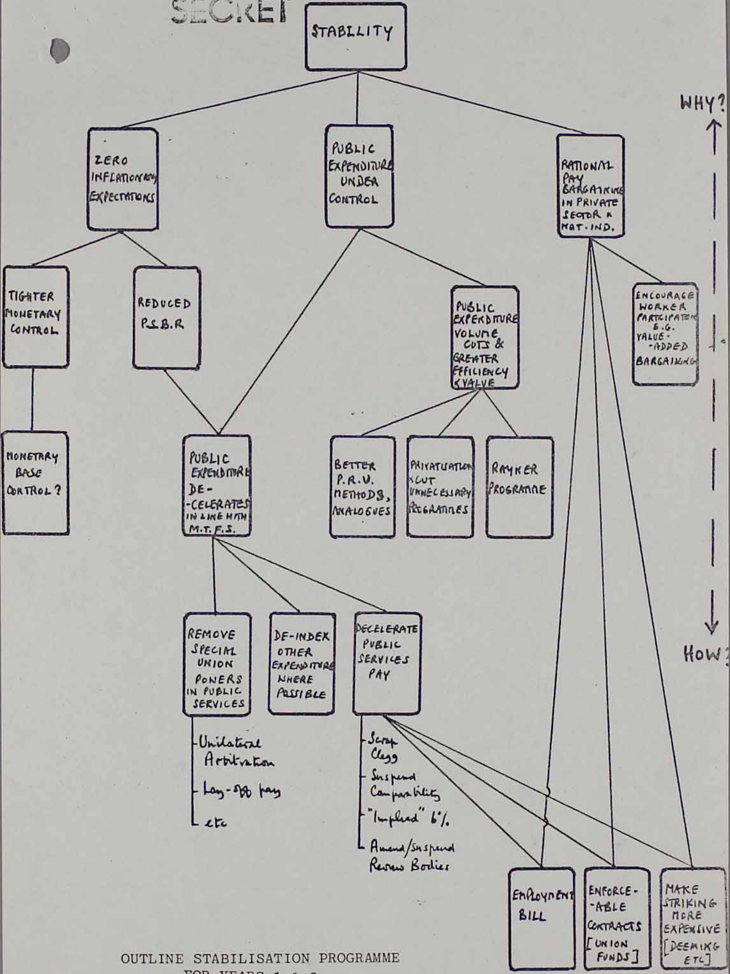


OUTLINE STABILISATION PROGRAMME
FOR YEARS 1 & 2
FIGURE 5

SECRET

4. THE CABINET STILL DOESN'T UNDERSTAND THE PROBLEM, cont.)

- Developing, and building into the system, the Rayner methodology, together with a further squeeze on public spending when the upturn comes (just the moment when Governments tend to relax; it needs to be sold for 18 months ahead so that the public are ready for it).

- Sustained education in economic reality, so that, at the margin, voters at the next Election judge our performance by more realistic criteria.

- Making sure that the Government gets the real growth industry of the future - information technology - off to a flying start. (We have - perhaps - managed to prevent this running into the sand before it starts.)

- The beginnings of more radical thinking about NHS, education, etc.

- Greater urgency to the "Accelerator" programme (MISC 14/15).

- Constitutional reforms to safeguard the country against extremist politics in the future.

All this should be built into a coherent and impressive forward-looking programme to give weight to the 1983/4 Election Manifesto.

4.3.2 In addition, we would still need to introduce further fundamental reforms for the trade unions. Unless we do that, we shall always have to choose between recurring inflation followed by slump; or else an economy running in a state of permanent recession with the public sector as the only growth area (ie what we are doing at the moment). Unless trade union power is reduced, the corporate sector cannot rebuild its profits, public services pay cannot be curbed, nationalised industries will continue to raise their prices faster than inflation. The measure of our immediate problem is that in three years we have not produced a team which really understands what has to be done.

5. BREAKING OUT

5.1 Official papers and Cabinet Committees are not enough

5.1.1 The conventional Westminster-Whitehall practice is inappropriate for a state of economic emergency. It does not distinguish those aspects of policy which are crucial to the turn-around task (eg the tasks on the "Christmas tree" in Figure 5). To overworked Ministers, all issues begin to look equal. (Indeed, given sufficient pressure and stress, all stimuli are eventually equal.)

5.1.2 Westminster-Whitehall conventional wisdom reflects the "art of the possible". It does not recognise that, in crisis, the key to success is to break constraints rather than accommodate to them. Even if it did, constraints cannot be broken around the Cabinet table, where that same conventional wisdom is seen as evidence of the essential experience needed for high office (much as the experience of generals "fighting the last war" is over-valued). There can be no "new data" and therefore no changes of mind, because new ideas, different people and fresh experience never penetrate these discussions.

5.1.3 We have been, and are still being, boxed in by the familiar constraints which have defeated previous Governments. For example:

(1) "We can't break our commitments on indexing social security."

(2) "We can't move faster on trade union reform without being thrown out of office by civil uproar."

(3) "We can't let industry bear the brunt after the personal sector has done so well." But:

(5.1.3 cont.) (4) "We can't raise direct taxes in view of our Manifesto pledges, especially as we've already reduced them."

(5) "We can't finance even <u>sensible</u> investment by nationalised industries outside the PSBR."

(6) "We can never win against the miners."

(7) "We can't bring fresh blood into the top of the Civil Service."

(8) "We can't liquidate state-owned lame ducks because of the PSBR impact."

(9) "We can't find the time to work out how to break any of these constraints."

<u>Acceptance</u> of these constraints is tantamount to saying: "On reflection, we've decided we can't succeed". If we were fighting a military, rather than an economic, war of survival, we would find ways of breaking such constraints inside a week. A business facing bankruptcy would do likewise. Constraints are broken quickly enough once the whole management team recognises the alternative.

<u>Each</u> of these constraints is breakable provided we have:

(a) Convinced all the colleagues that it <u>has</u> to be broken.

(b) Charged an individual, with the authority and resources, to find a way of breaking it - or else.

(c) Set up the right political communications to gain public acceptance.

(d) Set these things in motion <u>in time</u> (because strategic thinking alerted us early enough, to their importance).

5.2 Organise to achieve tasks, not to run hierarchies

5.2.1 Once the central turn-around problem is understood, then the tasks to be performed become clear. Once the tasks are clear (for example, breaking certain of the constraints in 5.1.3 above might form key tasks, but there will be many others) the traditional Whitehall approach (part-time, non-dedicated committees) is hopeless; good people, whether from within or outside the system, make little difference. The only way to achieve an important strategic task (by definition complicated and trans-departmental) is to give it to a task force, led by someone who is given clear objectives and motivated to succeed. Only task-organisation brings people together on a "results-orientated" basis for long enough to allow them to shelve departmental loyalties and the distractions of other work. (Anyone who reacts to this by saying that Whitehall can't work that way is accepting without question one of the conventional constraints.)

5.2.2 With the proper organisation to achieve the tasks that matter, goes the proper use of time: time in diary terms in order to think, discuss and plan; lead time needed to remove political constraints. (For example, we had a full year in which to prepare colleagues and the public for de-indexing, but never used it.) There will always be a limited amount of time, talent, experience which must be concentrated on the tasks that really matter. Otherwise we go on doing what Governments always tend to do: a little bit of everything, but none of it good enough or sufficiently constraint-breaking to make any difference.

5.3 We must start communicating

5.3.1 A second five-year term is essential for the strategy and thus for the country. We will only get it if voters recognise that this Government is qualitatively different from its predecessors. If they feel that, after all the hopes of 1979, we are really no different, no more competent, imaginative or determined than earlier Governments, then we shall be judged on the straight indicators of living standards and inflation, and could well be defeated.

5.3.2 Although great effort goes into speeches etc, all the feedback is that we are not communicating successfully. Everyone we talk to says that the Government does not explain why it is doing what it is doing; that people are unpersuaded that the sacrifices are going to lead anywhere; that the Government shows no signs of an adequate grasp of the problem and what national recovery really entails; that you personally should speak more often on television to educate and explain; that we have no "fast response" system for demolishing Labour's misleading propaganda.

5.3.3. None of this is surprising. Because we have only a sketchy outline of a strategy for turn-around, so we have no strategy at all for communicating that turn-around strategy. Despite all the talking and writing about communications in Opposition, we have not begun to put it into practice. If we go back to the original Stepping Stones paper, we said that any Government which was to have a chance of achieving an economic miracle (for that is what it has to be) will need to develop:

(1) a shared understanding of the UK problem, as a prerequisite for developing the -

(2) turn-around policies, which must be assembled into -

(3) a turn-around strategy for both policy and communications - they cannot be separated. The supporting communications strategy must be based on an understanding of -

(4) the nature of the communications process.

(5. BREAKING OUT, cont.)

Since we have scarcely achieved (1) above, it is not surprising that we have not yet started on (3) and (4).

5.3.4 We have a great advantage over Labour, because we can develop and present a coherent and convincing strategy, whereas they cannot. But we are not yet exploiting that advantage. It is essential that we do so between now and the next Election.

5.4 Is it worth the effort?

5.4.1 All this is difficult and time-consuming. It is the sort of work whose value cannot be appreciated until it has been done. It is the difference between successful and unsuccessful companies and, we would guess, part of the difference between, say, the French Government machine and our own.

5.4.2 The question is whether colleagues and officials can be persuaded to change. There is no possibility that, without changing their own method of working, Ministers and officials can somehow become superlatively effective, where before their performance was mediocre.

5.4.3 The initial investment of effort, in order to define the Government's position, aims and programme of action was never made by this Government, nor of course by its predecessors. (We attach at Annex A an interesting letter about the Labour Party's experience, much of it relevant to us.) This "strategic investment" is precisely analogous to building any other productive asset like a factory or a power station. You have to invest resources, time and effort, to build it, and further resources to learn how to operate it. Because it takes effort and because it cannot produce instant results, the temptation to put it off and argue that it is unnecessary is very powerful. But it catches up with us in the end. What we are now doing, as a Government, is working overtime to try to get "output" from something we never built in the first place.

6. CONCLUSION

6.1 This paper poses the following questions:

(1) Are you satisfied that the Government's central strategy is going well enough?

(2) If not - is this due to lack of clear objectives, or lack of an adequate strategy, or failure to implement the strategy?

(3) If strategy or implementation are at fault - do you believe that colleagues and officials can put it right?

(4) If so - will they do it by trying harder? Or by starting all over again? Or by working in a different way? Or some combination of these?

(5) If putting it right requires working in a different way - where will this new way come from?

6.2 Out of the 90-odd Ministers and 1,000 officials representing the apex of the Government machine, there can be no more than about ten (the Policy Unit plus a proportion of CPRS' effort) working in a strategic way:

- trying to identify the make-or-break issues
- thinking ahead in time
- thinking across Departments
- trying to integrate policy and political communications.

How can we focus the massive intellectual resources of Whitehall to support and implement this kind of thinking?

6.3 There are scarcely a dozen politically appointed outsiders in the whole of Whitehall. We believe they could be used as

6. CONCLUSION, cont.)

"change agents" (the term used by Norman Strauss in 1976 when he warned you that the existing Westminster-Whitehall system was bound to fail). I am thinking particularly here of political advisers with business experience in getting things done - Derek Rayner, Robin Ibbs, David Young and ourselves. (But the numbers are still miniscule.)

6.4 About every six months since mid-1978, we have come back to you on this central question of the sheer scale of the UK problem and the complete inadequacy of our organisation and our mode of operation for solving it. We have done so, with increasing emphasis since December 1979 on the need for a "shock" approach to get back on track, rather than a gradualist approach, because time is getting short.

6.5 <u>Proposed next step</u>

6.5.1 New insights, understanding, ideas emerge from discussion and argument, not from reading papers. I would like to propose a half-day informal discussion in the New Year, probably over a weekend. This would involve yourself and perhaps a few other colleagues, together with Robin Ibbs, Derek Rayner (if he is still available), David Young, David Wolfson, Norman and myself.

6.5.2 Our aim would be to convince you that colleagues can operate as a more effective and united team, if they can be persuaded to work in a different way. If we cannot persuade you that the effort to change would pay off, then we will drop the subject and revert to our normal role of "doing our best" within the constraints of Whitehall convention and the "art of the possible".

Draft.
(Publication - projected for 18/12)

PRIME MINISTER

PA (CF file) MS 8/1

PRIVATE - IN ADVANCE

The Treasury and Civil Service have agreed to the following Report

GOVERNMENT'S ECONOMIC POLICY : AUTUMN REVIEW

Introduction

1. This report updates the Committee's Second Report,[1] which examined some of the principal assumptions and forecasts behind the Budget and the Government's Medium-Term Financial Strategy and recorded the Committee's reservations and anxieties. We concentrate here on developments in the economy in the eight months since the Budget and on the prospects for 1981 in the light of the policy changes announced by the Chancellor of the Exchequer on 24 November, and of the Treasury's latest forecasts. The Government's economic strategy in the longer term will be discussed in the separate report we will be making on monetary policy early next year. We took oral evidence from Treasury officials on 1st December and benefited from useful papers from the Economist Intelligence Unit[2] and the National Institute of Economic and Social Research.[3] Once more we are indebted in the preparation of this report to our advisers, Dr Alan Budd, Dr Paul Neild and Mr Terry Ward.

2. We fully understand that the Government's policy is intended to achieve its objectives in the medium term; but that does not mean that the short term can be ignored. The medium term strategy must take the possible short-term costs into account. It is possible, indeed, that the short-term costs are so high that they could endanger the achievement of the longer term objectives. Also, the credibility of the medium-term strategy must depend on what is happening to the chosen instruments of policy and to the economy itself in the short term. Divergence from the path laid down on the scale witnessed in past months must jeopardise the credibility of the strategy, when we are told that the strategy itself depends upon changing people's expectations.

Recent Developments and Prospects for 1981
(a) Gross Domestic Product and the components of demand

3. Figures for 1980 are still incomplete. There is a preliminary estimate for GDP (the output estimate) and for consumers' expenditure for the third quarter of the year. There are figures for exports and imports of goods for the third quarter and there are provisional figures for investment and stockbuilding by the manufacturing and distributive industries for the same period. It is thus too early to forecast with any certainty the outturn for the year as a whole.

4. The Treasury's most recent forecasts are shown in Table 1 where they are also compared with the forecasts published with the Budget. If 1980 proceeds as the Treasury now expects, the expected fall in GDP will be 3%; close to the 2½% fall originally forecast by the Treasury in the Financial Statement and Budget Report for 1980-81. In general, the forecasts of

the components of demand fall within the average margins of error. There are however two cases in which the error is particularly large - stockbuilding and imports. The two are related. Companies have run down stocks in response to the financial squeeze and the general economic climate and in particular have reduced imports. Table 1 also illustrates the Treasury's point[4] that, so far, the recession has been caused by domestic factors rather than external factors in that the growth of UK export markets has been relatively buoyant although the UK's share of those markets has fallen this year.

5. It will be noted that the volume of General Government expenditure on goods and services has not fallen as much as forecast earlier. It is the only element of domestic demand proving to be higher than had been forecast.

6. The forecast that GDP will fall by 1½ percent in 1981 as a whole implies that output will start rising early in the year. (The Treasury's forecasts by half years show marginal increases in the first and second half of 1981.) In their evidence to us on December 1st, Treasury officials confirmed this view but were reluctant to state precisely when they expected the turn in the economy to occur.[5] (In July last Treasury officials were predicting an upturn later on in 1981). The major part of this projected recovery is based on the expected movement in stockbuilding between the second half of 1980 and the first half of 1981.

7. So far there is no direct evidence to support the Treasury's view that there has been a rapid fall in stocks in the second half of the current year. The only figures available for stockbuilding are those for manufacturing and distribution, which provide only an approximate guide to developments in the whole economy. The most recent figures here, which cover the third quarter of the year, show only a small fall in stocks. It is quite possible that stocks are falling sharply in the fourth quarter of the year, but stockbuilding is a highly volatile and ill-measured element of expenditure. Thus the listed evidence available provides a precarious foundation on which to base expectations of an early recovery in the economy. Further, the ratio of manufacturers' stocks of finished goods to production in the third quarter of the year was at least 20 per cent above the average for the previous five years[6] and would still be well above this average even if the Treasury's assumptions of rapid destocking in the fourth quarter proves valid. There thus seems room for further substantial destocking during 1981. This if it were to occur would have the effect of postponing any recovery to a considerably later date than the Treasury is forecasting.

8. The main areas of anticipated weakness next year are exports and fixed investment (both private and public) where falls of 3% and 6% respectively are foreseen. The projected drop in investment is a source of major concern for several reasons: it represents a substantial change from the time of the

Budget; the fall has important implications for employment and production; and above all it is to investment and to exports that we must look for future sustained economic growth.

(b) Manufacturing output

9. Manufacturing output in September was about 10 per cent lower than a year earlier and is now at a level not seen since the mid-1960's. The Treasury, moreover, sees no growth over the coming 12 months. The official forecast of an average 4½ per cent fall in manufacturing output for 1980 as a whole was reported in oral evidence by Treasury witnesses on 2nd April, and reaffirmed on 14th July.[7] The Treasury now expects the fall to be of 10 per cent, implying a further significant fall in the fourth quarter of 1980.

10. The expected fall in manufacturing provides striking evidence of how uneven has been the burden of the recession. On the Treasury's own figures, the expected fall in manufacturing output accounts for the entire fall in GDP. In other words, public and private services (and North Sea oil production) have been stable or have continued to grow while the manufacturing sector has experienced its most severe post-war recession. The error in the Treasury's forecast indicates the extent to which this development was unforeseen at the time of the Budget.

11. The Treasury now forecasts a fall in manufacturing output in 1980 compared with 1979 of 10 per cent and a further fall in 1981 compared with 1980 of 4 per cent. No comment of the Committee is needed to emphasise the gravity of these figures.

12. In evidence to us the Treasury stated:

> "These forecasts have prompted suggestions that, taken with the latest monthly estimates of industrial production, a sharp increase in output in the course of 1981 is implied by Treasury forecasts. This is not so".[8]

The Treasury go on to support their view by reference to figures for 1980 and 1981, half-year by half-year, which show manufacturing output much the same in 1981 as in the second half of 1980. As manufacturing output is expected to fall between the third and fourth quarters of 1980, these figures imply that the fall should come to an end fairly soon and be replaced by a rise during 1981. However, in July last, the Treasury were predicting that the turn round would not take place until later in 1981. Professor Burns modified this view in his evidence to us on 1st December when he said:

> " ... the level of output should now be getting close to the point where it ceases to fall any further, but I would not wish to be pinned down in terms of a few months when that might take place".[9]

In fact, we have seen no convincing evidence that the fall is coming to an end. It is premature to attempt a conclusion particularly bearing in mind that the Treasury believe their forecasts of manufacturing output are subject to a possible error of 4 per cent either way.

(c) The exchange rate and competitiveness

13. The Treasury's 'Economic Prospects to End 1981' notes in paragraph 6 that:

> '... there has been a large and indeed unprecedented loss of competitiveness. On the basis of relative labour costs, the level of competitiveness in 1980 is estimated to be some 40-50% less favourable than in 1978.'

In other words our unit labour costs when measured in terms of a common currency have increased by 40-50% more than those of other countries over this period. In evidence to us on December 1st the Treasury's Chief Economic Adviser, Professor Burns, said that the current level of sterling could not be explained 'in terms of the normal things which one attempts to bring to bear on this subject'[10] and in this he confirmed earlier evidence from the Bank of England. Although the economy has to some extent been shielded from the full effects of the exchange rate appreciation by the buoyancy of UK export markets, the Committee is concerned that the Treasury finds largely inexplicable a factor having a major impact on manufacturing industry in terms of its ability to compete at home and abroad. This leaves open the question whether and to what extent the exchange rate can be influenced by the authorities.

(d) Unemployment

14. Unemployment (including school leavers) in the UK was 2,163,000 in November. The seasonally adjusted figure for the UK (excluding school leavers) was 2,028,000. This total has risen by nearly 700,000 since the beginning of the year. In the past 3 months alone it has risen by over 330,000.

15. The technical assumption used in the Public Expenditure White Paper (Cmnd 7841) was that the average rate of unemployment in 1980-81 would be 1.6 million for Great Britain. This unemployment figure was defended to the Committee as plausible by the Chancellor of the Exchequer as recently as 28th July.

> "I think the position is this. The level of unemployment, if one looks at the Public Expenditure White Paper published at the same time as the budget, is assumed at a figure for Great Britain, excluding school leavers, for 1980-81 at an average 1.6 million. The current figure so adjusted is 1.536 million and is not, so far as I can judge, significantly out of line with that which was anticipated at the time of the White Paper."[11]

The assumption used for the Government Actuary's calculations for 1980-81 has now been revised upwards to an average for the year of 1.7 million[12] The fact that the November figure for unemployment (GB excluding school leavers) is already 1.9 million shows the difficulty in interpreting annual averages.

16. In their evidence on December 1st, Treasury witnesses explained that the movement in unemployment (like the movement in manufacturing output) was exceptional in relation to GDP. The rise in unemployment was to a great extent the response of companies, particularly in the manufacturing sector, to the financial squeeze that was imposed upon them. The squeeze could have been anticipated and, indeed we specifically drew attention to the possible dangers in our Second Report of last Session.[13]

17. The assumption provided by the Treasury for the Government Actuary is that unemployment will be at an average level of 2.3 million in Great Britain in the fiscal year 1981/2. Treasury witnesses on 1st December indicated that this figure was unlikely to be 'grossly misleading'.[14] The Committee were not clear what this meant. Our concerns about unemployment are reinforced by the statement of Treasury witnesses to us on 1st December that employment levels could not be expected to stop declining until late in 1981.[15]

18. It should further be noted that unemployment would be significantly higher than it currently is were it not for the various employment subsidy schemes in existence.[16] Moreover, to the extent that the recent rise in unemployment has been due to a shake-out of labour in manufacturing, any recovery in output when it comes will have a smaller than usual effect on employment prospects. In which case given the projected growth in the labour force, unemployment could go on increasing for some time to come.

(e) The Corporate Sector

19. Official statistics for profits tend to be subject to very large revisions. The figures for industrial and commercial profits in the first half of 1980 were both stronger than expected and at variance with alternative indicators of profitability. Company returns for the third quarter suggest a most severe fall in profits with an accompanying squeeze on liquidity.

20. Industrial profits pre-tax and before deducting stock appreciation are likely to fall significantly in nominal terms this year compared with last, judged by the evidence of company results so far published. The demand for external finance from the industrial and commercial sector is estimated by our advisers to be almost £7½ bn this year compared with a little under £6 bn last year. Moreover, these figures, though bad, would have been considerably worse had not the manufacturing sector already laid off large numbers of employees and run down stocks.

21. The recession has also hit the nationalised industries which, because of the fall in their trading profits, have been forced

to borrow significantly more than originally forecast. In our Second Report we questioned the assumptions about improvements in the nationalised industries' finances in the White Paper.[17] Developments since then show that our fears were well founded. As Professor Burns of the Treasury said in evidence to us on December 1st:

> "What is clear at this stage is that the fortunes of the nationalised industries both for this year and next year look worse than what was predicted in the public spending White Paper".[18]

22. This decline in profits has had the effect of forcing both private companies and nationalised industries to cut back planned investment, inevitably weakening the industrial base of the economy - upon which a sustained recovery in output and employment will depend.

23. In "Economic Prospects" the Treasury explains the deterioration in the company sector's financial position in terms of : "a widespread acceleration of domestic costs; a rising exchange rate; and falling profit margins". To this list could be added the fall in their sales and exceptionally high short-term interest rates. In our Second Report we commented:

> "The Committee feel that there are several factors which together tend to indicate that the corporate sector will face a substantial liquidity squeeze not only in the short-term, but probably in the medium-term as well. Amongst these, we may cite the projected slow growth in overall economic activity, high interest rates, the squeeze on profitability from the effects of a continuing strong pound (which adversely affects exports while boosting imports), and the difficulty in resisting high pay settlements in the private sector when public sector earnings growth and interest rates are both high."[19]

We warned that the corporate sector might have to bear a large proportion of the overall burden of adjustment required to meet the targets of the financial strategy. In "Economic Prospects" the Treasury's 1981 forecast of profits is limited to the following:-

> "Profit margins have declined very sharply in 1980: the prospect for next year is highly uncertain, but margins may not decline as much again".

We have previously stated and we reiterate that the Government must be prepared with measures to relieve what continues to be a "very damaging deficit".[20]

(f) <u>Inflation</u>

24. Inflation as measured by the RPI between the fourth quarter of 1979 and the fourth quarter of 1980 is likely to be 1 per cent lower than the Treasury's Budget forecast of 16½ per cent. The short-term rate is considerably lower and inflation appears to be decelerating rapidly.

25. This reduction in the inflation rate can be regarded as a success. However, as we shall discuss, it is not easy to relate this success to a close control of the money supply. Moreover, success has been achieved at the cost of a severe squeeze on profit margins, partly brought about by the increase in the exchange rate, and at a considerable cost in terms of lost output and jobs.

26. For the purposes of their forecast the Treasury assume that the current high level of the exchange rate will be maintained. If this turns out to be the case there will be no let up of pressure on the exporting sector which in 1981 may additionally be facing less buoyant markets than those of this year.

27. The Treasury's forecast that prices will rise by 11 per cent between the fourth quarter of 1980 and the fourth quarter of 1981 seems to be on the high side since, on the Treasury's own estimates, the underlying rate is already at about that level. The caution may however by justified since (as we have already said) the current reduced rate of inflation has been effectively achieved by a squeeze on profit margins. The Treasury suggests that the squeeze has taken "several percentage points" off the current level of retail and wholesale prices. If demand does recover next year it is possible that companies will respond by restoring margins. Pay pressures may also grow. We have heard nothing to relieve our fears that the current reduction in inflation will be reversed to some extent if and when the economy recovers.

(g) The Public Sector Borrowing Requirement

28. The PSBR in the first half of 1980-81 was £8 billion. This compares with the Budget forecast for the year as a whole of £8½ billion. The Treasury has provided only broad explanations for the over-run, and in response to a request from us for more detailed information did little more than repeat the material presented in 'Economic Prospects'.[21] There has been, according to the Treasury some overspending on defence, on agricultural support, and by the local authorities. Debt interest is now estimated to be £½ bn higher than earlier forecast, and costs in the public sector, particularly pay, have risen further relative to prices generally than was expected. In the absence of any detailed quantitative estimates the Committee find it impossible to make an adequate assessment of the reasons why the PSBR has so greatly exceeded the Budget forecast level. The matter merits further explanation. We shall be pressing for a detailed breakdown of the figures from the Treasury.

29. As noted above, nationalised industries have been particularly severly hit by the recession and their need for additional borrowing has contributed significantly to the rise in the PSBR.

30. In our Second Report we also questioned the Treasury's forecasts of the relative price effect which measures the difference between the rate at which costs in the public sector increase relative to inflation generally. We commented, "the cost of the Government's programmes in 1980-81 may be higher than that shown in the White Paper on account of the differential between the large increase in public sector pay compared with private sector pay for the 1980-81 financial year."[22] As far as we can tell from the figures provided so far this observation has proved well founded.

31. The revision of the forecast for the PSBR for 1980-81 from £8½ billion to £11½ billion understates the forecasting error since the new figure would be £650 million higher but for the reduction in the EC contribution which was not taken into account earlier. Thus so far there is an estimated error of £3.65 billion.

32. Paragraph 29 of 'Economic Prospects' states: "After taking account of the tax changes announced on 24 November, revenues from North Sea oil and gas in 1981-82 are expected to be in the range £4½-£5 billion, at 1980-81 prices, a little higher than forecast at the time of the Budget". Since the proposed tax changes were expected to raise around £1 billion in 1981-82 the Committee were puzzled by the reference to revenues only being "a little higher than forecast at the time of the Budget". We questioned the Treasury on this, and were told by the Chancellor[23] that oil production forecasts for 1981-82 had been revised somewhat downwards and capital expenditure (which attracts tax allowances) revised upwards. In the Treasury's view these two developments about cancel out the yield in 1981-82 which is expected from the tax changes. The Committee may well wish to examine the matter of oil revenues further.

33. The Treasury is understandably reticent about forecasting the PSBR for 1981-82 given the very large margins of error already revealed for the current year. "Economic Prospects" mentions a number of favourable factors for 1981-82: the fiscal measures of November 24th; the improved financial position of public corporations [sic]; and lower pay increases in the public sector" - all factors which may outweigh the continuing effects of the recession - and estimates that the PSBR may fall as a percentage of GDP, which may well be consistent with an increase in its absolute level.

34. We do not have adequate information to judge the validity of the Government's figures for 1981-82. The public expenditure changes announced on November 24th only listed the effects of policy changes; but in the past far larger changes have arisen from "estimating changes". The Treasury tells us that it cannot at present provide additional information for 1981-82. We find this surprising. The Treasury are also unable to give us an estimate of the out-turn for public spending in the current year.

(h) Public Sector Pay

35. In our Second Report we said we were not convinced that cash limits were fully effective in controlling public sector pay. We therefore intended pursuing the matter with the Chancellor.

36. This we did in our Fifth Report,[24] the Treasury's observations on which were published in our Third Special Report.[25] Briefly, we expressed our continuing concern about the way cash limits could be evaded by staging or delaying payment and by double counting, so far as the Civil Service was concerned, in taking credit when settling pay for reductions in numbers which would have taken place in any case. We were also concerned that the presentation of the split provision for Civil Service pay between the main departmental Estimates and the global Estimate for pay increases tended to cause confusion as the figures were not brought together in any one place.

37. The Treasury's observations seemed to show that the Committee had failed to convince the Treasury on these important points. We were therefore all the more pleased to learn from the Chancellor's letter of 24th November[26] that on further reflection the Chancellor had come to agree with the Committee particularly on the undesirability of staging and the need for provision of full information. The Committee welcome these developments and have set out their understanding of the present position in the Chairman's letter of 26th November.[27]

(i) The money supply

38. The annual rate of increase in sterling M3 - the key element in the government's medium-term financial strategy - was 24 per-cent during the period February to November. Other measures of money growth show smaller rises. (M1 has for example grown at an annual rate over the February-November period by around 8%, PSL 1 by around 20%.) The upper limit for £M3 was put at 11% for 1980/81. When this limit was announced it was recognised that the removal of the "corset" would involve some acceleration of monetary growth. Allowing for this, recent estimates by the Treasury put the annual growth of £M3 at 19%, well above the upper limit of the target range. Preliminary figures for November point to this annual rate rising to 20%. As recently as July 28th the Chancellor confirmed to us that he believed the money supply was probably under control.[28] £M3 is the target the Government has chosen to emphasise. We shall comment on the wisdom of this choice in our forthcoming report on monetary policy.

39. In their evidence to us on December 1st, Treasury officials provided four explanations for the rapid growth of sterling M3. The first was the effects of removal of the corset which had been much larger than expected. The second was the unexpectedly rapid growth of the PSBR. The third was the effects of external finance following the favourable movement in the current account of the balance of payments. The fourth

was the continued high level of bank lending. This list covers virtually all the possible sources of monetary growth and is tantamount to saying that the money supply has risen because the money supply has risen. It does not hide the fact that the Government has not achieved the one target to which it was absolutely committed.

40. "Economic Prospects" includes the following statement about monetary growth in the remainder of the financial year:

> "Thus the forecast of underlying monetary growth over the target period of February 1980 to April 1981 is that it will come back towards the top of the 7-11 per cent range".

Such a vague statement might simply mean that by next April the money supply could be growing at an annual rate of about 11 per cent; it implies nothing about the expected growth over the target period as a whole. This deliberate uncertainty was confirmed by Professor Burns' statement that he was not prepared to tell us what he thought monetary growth would be from now to the end of the fiscal year.[29] Professor Burns also remarked:

> " ... in fact there is very little that the Government can now do which would influence the rate of monetary growth between now and the end of the current target period. We are not in a position of taking further fiscal action which might do a great deal. Furthermore, any changes in interest rates are unlikely to do a lot between now and then".[30]

We have not been convinced that this is necessarily so. It is clear to us that there has been a suspension of the money supply numbers in the Medium Term Financial Strategy until the 1981 Budget, numbers the Government has said were central to its economic strategy.

41. In the November statement the Chancellor announced the reduction of MLR by two points, before any clear evidence of a decline in monetary growth was apparent. On December 1st officials explained this action to us in terms of a broader view of economic developments as a whole and also suggested that there was beginning to be a fall in corporate loan demand.

42. In his statement of November 24th, the Chancellor said that the Budget will be designed "to ensure that the thrust of the medium term financial strategy is maintained". We are not clear what this means.

43. We have expressed our reservations in the earlier paragraphs of this Report. We will be making a further report to the House at the time of the Budget. The Chancellor's statement of 24th November taken together with the Industry Act forecasts did not, of course, provide the full information that will be available at the time of the Budget and the next Public Expenditure White Paper.

Footnotes

1. "The Budgets and the Government's Expenditure Plans 1980-81 to 1983-84", HC(1979-90)584
2. Appendix 6
3. Appendix 7
4. "Economic Prospects to End-1981"
5. Q16
6. Economic Trends, November 1980; "British Business", Nov 28 1980
7. HC(1979-80)679-iii, Q 335
8. Annex 2 to oral evidence
9. Q 16
10. Q 114
11. HC(1979-80)679-vi, Q 655
12. Cmnd 8091
13. HC(1979-80)584
14. Q 44
15. Q 51
16. These cover 668,000 people (Secretary of State for Employment, Official Report, 9 December 1980, Col. 1172); according to the Department of Employment the effect on the unemployment register is of the order of 250-300,000 people.
17. HC(1979-80)584, paragraph 17
18. Q 31
19. HC(1979-80)584, paragraph 27
20. ibid., paragraph 29
21. Annex 1 to oral evidence
22. HC(1979-80)584, paragraph 21
23. Chancellor's letter of 11th December; Appendix 8
24. "Provision for Civil Service Pay Increases in the 1980-81 Estimates" HC(1979-80)730
25. HC(1979-80)819
26. Appendix 3
27. ibid
28. HC(1979-80)679-vi, Q 671
29. Q 76
30. Q 63

TABLE 1

FORECASTS FOR 1980 & 1981

	Budget	Industry Act November 1980		Margins of error	
	1980	1980	1981	1980[1]	1981[2]
GDP	-2½	-3	-1½	1	1½
Consumers expenditure	1	0	-½	1	1½
General government expenditure	-2	-1	-2	1½	1½
Other fixed investment	1	½	-4	3	4
Exports of goods and services	½	1	-3	2½	3½
Change in stockbuilding (as percent of GDP)	-2	-4	1	¾	1
Imports of goods and services	2½	-3	0	2	2½
Manufacturing output	-4½	-10	-4	4	
Balance of payments current account £ billion	-2¾	2	2		2
Retail price index (4th quarter 1979 to 4th quarter 1980)	16½	15½	11	2½	3
Public sector borrowing requirement (Financial year 1980-81) £ billion	(8)[3] 8½	11½		3	

[1] as estimated in Budget Forecast
[2] as estimated in Industry Act forecast, November 1980
[3] adjusted for E.C. refund

19 December 1980
Policy Unit Geoff PU

I think you have left out one thing which both politicians & businessmen have to take into account - the unexpected world economic climate because of cont. oil price increases.

PRIME MINISTER

GOVERNMENT STRATEGY

not.

We will be putting to you on Monday, as promised, our STRATEGY PAPER NUMBER 3.

The questions we have to ask in reviewing Government strategy seem to me to be these:

(1) Are you satisfied that the Government's central strategy is going well enough?

(2) If not - is this due to lack of clear objectives, or lack of an adequate strategy, or failure to implement the strategy?

(3) If strategy or implementation are at fault - do you believe that colleagues and officials can put it right?

(4) If so - will they do it by trying harder? Or by starting all over again? Or by working in a different way? Or some combination of these?

(5) If putting it right requires working in a different way - where will this new way come from?

The paper is written from the businessman's viewpoint: that is, it assumes that when things do not go according to plan, you must look at the organisation and the way of thinking and working, rather than at the people concerned. Business experience suggests that even the ablest people are quite useless if the approach and organisation is wrong. The quality of people alone is not enough. Experience at making new things happen counts too. This is an entrepreneurial skill.

In the Policy Unit, we are amateurs in the political field, in the Parliamentary and legislative process. We would fall flat on our faces if we suddenly tried to operate in that area. But I think you accept that the businessman's way of thinking really does have something to offer to politicians and senior civil servants who do not get much training or direct experience of management as such. This is where I think we, and other political advisers with business backgrounds, can make the best contribution.

Papers - whether good or bad, short or long - can achieve nothing by themselves. I hope we shall have a chance to discuss the paper (which I will copy to Geoffrey and Keith) in the New Year.

JH

JOHN HOSKYNS

CONFIDENTIAL

cs

cc AD
JV

Prime Minister

PRIME MINISTER

TL
19/12

PAY BRIEF

I attach my Department's pay brief for December. We have circulated briefs like this every month to E(EA) members. With the new arrangements for monitoring pay, I think it worth giving these briefs wider circulation. I am therefore copying this to members of E, E(PSP) and E(EA) Committees, and to Sir Robert Armstrong.

JP
19 December 1980

PAY BRIEF - POSITION IN MID-DECEMBER

SETTLEMENTS

1 Since the November pay brief 68 settlements covering 763,000 employees have been reported. Only 4 (257,000 employees) are in the public sector. The weighted average level of settlements over the last month was 9½% in the private sector and 10½% in the public sector.

2 The cumulative average level of settlements this round in the private sector has fallen again to 10½% (172 settlements covering 971,000 employees). Most of the settlements recorded so far have been in manufacturing industry, where the average level is just above 10%. Few settlements have been made in non-manufacturing industries: the average in non-manufacturing is 10½%, but this is heavily biassed by the low settlement in Agriculture (9%). There is a wide range of settlements (see Appendix 4). Most are in the range 10% to 15%. About a quarter are in single figures, almost all in engineering and clothing industries.

3 In the public sector (12 settlements covering 423,000 employees) the cumulative average is 14%. The average for the services sector is 19½% and for the trading sector is 9½%. The major settlements in the public sector since the November pay brief are for Coalmining at 9.7%, with a new settlement date of 1 November 1981, and the 2 stage agreement for Fire Services which increases costs in the firstyear by about 16% and about 18% when fully implemented.

NEGOTIATIONS

4 In the public sector, negotiations are due to open shortly for Local Authority manuals (4 November - 1,100,000) and craftsmen (4 November - 95,000) who are seeking substantial increases and a reduction in hours. Offers in reply to similar claims by NHS ancillaries (13 December - 211,000) and NHS ambulancemen (1 January - 17,000) will not be made until the NHS cash limits are announced. Preliminary discussions have begun on a claim by NHS craftsmen and maintenance workers (1 January - 14,500) for parity with the electrical contracting industry, estimated to be worth about 21%. A recommendation by Committee 'A' for a 13% increase for University Teachers (1 October - 38,000) was submitted to /DES

DES. An offer of 6% in line with the university cash limit has been rejected in the main negotiating committee (Committee 'B'). Gas Supply manuals (18 January - 41,000) have submitted a claim estimated to be worth 23%. Management will respond on 7 January. For Water Service manuals (7 December - 33,000) an offer of 9.9% on rates, estimated by the unions to be worth under 8% on earnings, has been rejected. Next meeting arranged for 6 January. Negotiations are continuing for British Airways (1 January - 50,000) where the proposal to defer the implementation of the settlement for 6 months and then to increase basic rates by 7½% has been rejected. National Bus Company (1 March - 38,930) and Municipal Buses (1 January - 20,750) platform and maintenance staff have submitted claims seeking substantial pay increases and other improvements. The main union representing British Steel manuals (1 January - 88,000) is expected to reject a suggestion for a pay freeze and to submit a claim at a meeting on 18 November.

5 In the private sector, unions on behalf of Ford manuals (26 November - 57,000) have rejected a 'final' offer of 9.5% on basic rates. The claim, which included a reduction in hours, is estimated to be worth 20%. Unions are to meet on 18 December to discuss future action. Merchant Navy officers (1 November - 36,000) and seamen (2 January - 26,000) have rejected offers of 9% and 10.5% respectively. Negotiations in Road Haulage (November 80/February 81 - 200,000) are taking place on a regional basis with the Road Haulage Association adopting a target of less than 10% in their regional negotiating groups. Settlements of between 4% and 6.8% have been reached in about half of the regions. Negotiations are continuing on a claim by Newspaper Publishers Association production workers (1 January - 33,000) worth 15%-16%. An offer of 5% has been rejected. Guardian Royal Exchange staff (1 January - 8,700) have been offered 9% in response to a claim for 14% with a reduction in hours. A 15-point claim for Oil Company tanker drivers (21 November - 8,500) has met with offers of 14.1%. Drivers at BP have accepted, but Shell, Texaco and Esso have rejected the offer. Talks have broken down on a final offer of 5.6% to 6.8%, according to grade, for workers in Motor Vehicle Retail and Repair NJC (1 January - 400,000). The Employers' Association has recommended that member firms implement the offer.

EARNINGS

6 In October the year on year increase in average earnings for the whole economy was 20.0% compared with 26.1% in September. Leaving aside temporary factors the September figure was about 21½%.

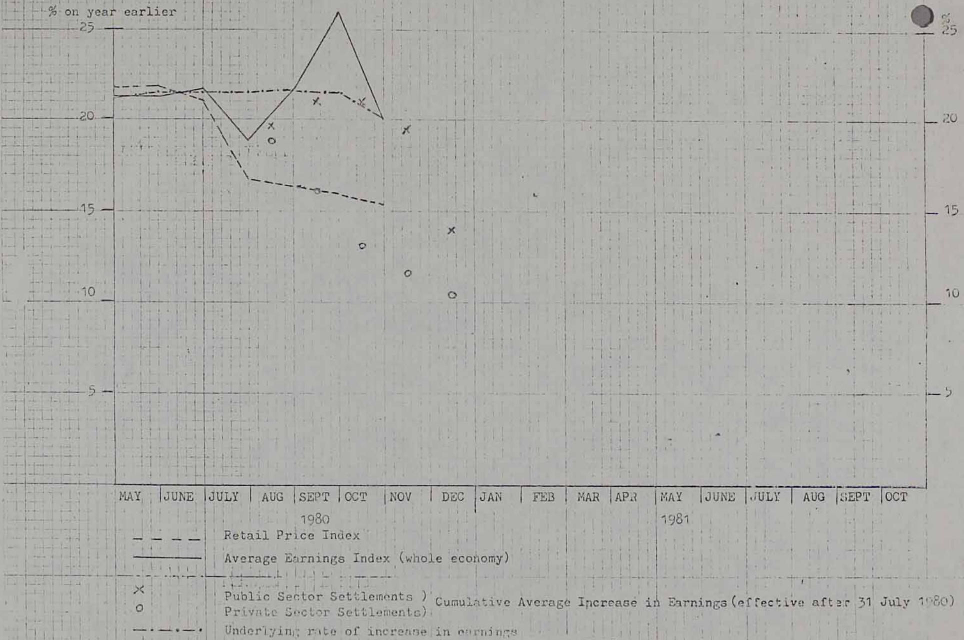
REAL DISPOSABLE INCOME

7 The real disposable income of a typical family (described in the mid-September Pay Brief) rose by about 3% in the year to September.

CONFIDENTIAL

APPENDIX I

TRENDS IN EARNINGS AND PRICES



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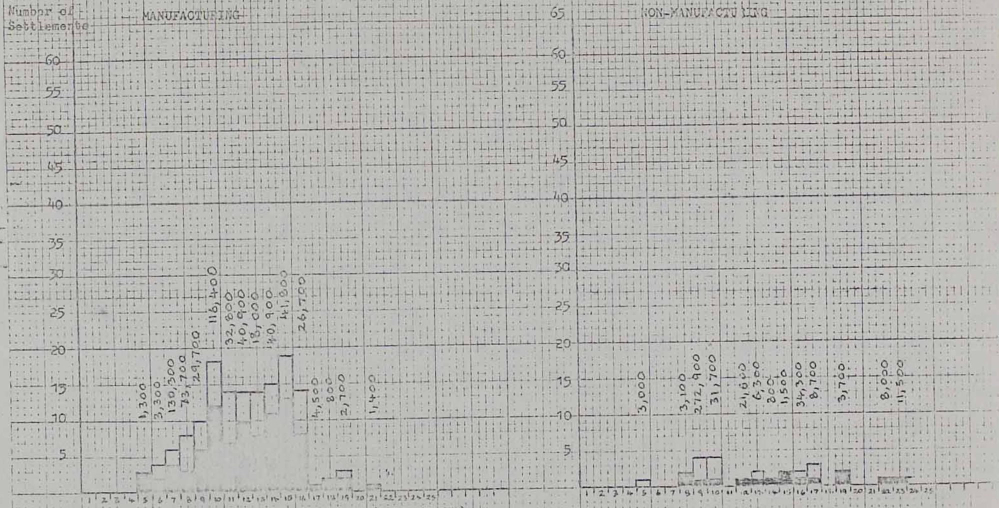
APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1980

KEY: SETTLEMENTS UP TO THE LAST PAY BRIEF
SETTLEMENTS SINCE THE LAST PAY BRIEF



LEVEL OF SETTLEMENT (ROUNDED TO THE NEAREST WHOLE NUMBER)

NOTE - THE NUMBERS OF WORKERS (ROUNDED TO THE NEAREST HUNDRED) AFFECTED BY THE SETTLEMENT IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

WORLD AT ONE — 18/12/80.

PA
(cf file)
MS
8/1

Mr. du Cann: Well what the Committee meant was really a matter of commonsense. There is now great public anxiety about the level of unemployment. For example that's one of the problems we have in the United Kingdom as other countries throughout Europe and the developed world have. And it may be that anxiety will be so great that it will call into question the very objectives of the policy which the Chancellor is pursuing.

Interviewer: Are you suggesting that those objectives cannot be obtained if the Government pursues its present course?

Mr. du Cann: No I wouldn't say that at all. I would say however that there is a risk that the Chancellor may well be knocked off course by the volume of political complaint that is bound to follow high unemployment.

Interviewer: You go on to talk about your anxieties about manufacturing output. You say you see no convincing evidence that the fall in output is coming to an end. What evidence has the Treasury offered to try to persuade you that it was?

Mr. du Cann: Well there are two aspects of this matter. The first is the fact that the fall in unemployment (corrects himself) the fall in manufacturing output is really very severe 14% over two years. And there is a great unevenness in the way in which commerce, industry and the economy in general is experiencing at the present time. For instance Government activity seems to continue almost unabated because the Public Sector Borrowing Requirement is so high yet on the other hand manufacturing industry is having a very rough time indeed. Now the second is this. Undoubtedly there is a great wish on the part of Government, on the part of all of us, to see the depression, which is a very severe and international thing, bottoming out. As yet there is no evidence of that and all that we have heard are expressions of wish that it should be so.

Interviewer: It seems to me that the Committee collectively has grave doubts about the accuracy of the Treasury predictions and forecasts. Not merely on that but on things like the control of the growth of the money supply.

/ Mr. du Cann:

Mr. du Cann: Well that of course is true, its very worrying that the money supply has continued to rise at the rate that it has. I think that if there has been a mistake its been that we on the Conservative side of the House, and I speak as a friend of and supporter of the Chancellor's, have allowed so much emphasis to go on to a single indicator. I feel the Bank of England today suggesting that M3 maybe is not the perfect indicator, certainly the Committee feels this and will be reporting on the subject in due course.

Interviewer: In fact the views of the Bank of England and the views of the Select Committee seem to coincide in many particulars.

Mr. du Cann: That's absolutely right. Not only do they coincide but they are very largely complementary I think too.

Interviewer: What do you make of the apparent criticism of the tightness of the monetary policy which has come from the International Monetary Fund today?

Mr. du Cann: Well I think that's misplaced. Because the truth of the matter is that although the Government have the label of being severely monetarist on any dispassionate observation its been very far from that.

Interviewer: What advice Mr. du Cann is your Committee giving to the Chancellor. You are clearly not very happy with what has been going on so far. Is there anything the Government can or should do to change its course in a way which would meet some of your criticisms?

Mr. du Cann: Well I think one of the interesting points that we are making is it seems that probably, this is inferential rather than directly stated in the Report, there is now no reason why interest rates should not be further reduced. Its quite clear that such tightness that there has been in terms of monetary policies has not necessarily had quite the effect that people expected.

Interviewer: Is there a further danger, do you think, that if the Government's hope that public sector pay is restricted to the 6% cash limit, if that hope is not fulfilled, that things may go from bad to worse.

/ Mr. du Cann:

Mr. du Cann: That is undoubtedly true and one of the very good marks that the Committee give to the Chancellor is for his immediate acceptance of recommendations that the Committee made in the way in which public sector pay is treated in the estimates and in terms of Government financing generally. It seems that the Treasury itself was less than keen on the fact that it is obviously necessary to get a degree of control over public sector pay but the Chancellor stepped in and apparently overruled.

Interviewer: Have you any feeling at all that the Government is riding a juggernaut which itself has started which it can no longer control?

R.V.F.

Mr. du Cann: I think that Government ought to point out much more frequently than it does that we are in the throes of a world recession. There seems to be a natural assumption that anything that goes wrong in the United Kingdom is automatically the fault of the domestic Government whatever its political complexion is. That obviously is rubbish. On the other hand, however, there are practical things that need to be done and picking up one of your earlier questions the Committee feels, I certainly feel passionately that we need as an Administration to be spending less on administration and very much more on investments.

* * * * * * * *

Interviewer: Sir Geoffrey, Mr. du Cann says that he is a friend and supporter of yours. Do you feel that he has been friendly and supportive enough in the Treasury Select Committee Report.

Chancellor: Well let me remove first of all a premise with which you introduced this interview referring to the level of gloom and doom and so on implicit in the Bank of England's Report being discussed today. The Bank of England's Report is making very much the same points as the Treasury's. The Deputy Governor of the Bank this morning said that they are entirely in line with us on the policy. And I think there is too much of a tendency to look always with gloom and doom when one is looking at forecasts. If you look at other

/ forecasts

forecasts at the London Business School, for example, and other forecasters, they are if anything more optimistic than the Treasury. Let's try to look at with a sense of reality and try to assess the role of Edward du Cann. I think the most important point that he was making as Chairman of the Committee was expressing a risk that the Government may be knocked off course by political complaint. Now my regret is, and this isn't the right time to reply in full to the Committee, that the Committee in preparing their Report did not have that more fully in mind. In his later remarks Edward du Cann criticised the Government for not making enough of the extent to which our economic problems flowed from the world recession. Criticised the Government for allowing people to think that all our problems could be solved by Government action, and so on. The truth is that it would be enormously welcome if this Committee Report itself had made those things, if it said that the problems that are facing us are the problems created by the world recession. If it had said that so far from expecting that our problems can be solved by altering the assumptions and Treasury forecasts that they depend on other things which are right outside Government control.

Interviewer: I think one point, Sir Geoffrey, that the Select Committee does repeatedly criticise is the lack of accuracy in some predictions the Treasury has made, for instance on the ending of the fall of manufacturing output, they have said that "we have seen no convincing evidence that the fall is coming to an end". They are critical of the growth of the money supply.

Chancellor: But again you see to criticise forecasts is to misconceive the role or the reality of forecasts in any economy. They are bound to have elements of error in them as I have just said, there are forecasts that are actually more optimistic than our forecasts on the likely date of the upturn of the economy. But I think that the Committee have become a shade too obsessed with what I might call "instant forecasting comment" rather than emphasising the important political realities, which as a matter of common ground I would like to see them getting through to the people the need, for example, for continued responsibility overwhelmingly in pay bargaining - the thing that far more than the exchange rate has damaged our competitiveness in recent years. There is no reference to that in the Report.

Interviewer: But presumably, Sir Geoffrey, Government strategy has got to be based on forecasts of some kind. Doesn't it? You have to take the Treasury forecasts and say this is probably what is going to happen?

Chancellor: Indeed, and there is nothing in the Report that suggests that the Government's strategy is based on a wrong assessment of forecasts. As I understand it their concern is the risk that we might be knocked off the course which by implication they commend, by short term difficulties. So this is one of the problems of a Committee of this kind. It's new in its existence. It's a development that I much welcome to try and extend the area of common ground and common understanding. A very difficult task for a Committee with members from very widely differing points of view and different parties, so there is bound at this stage to be a tendency for them to offer contradictory conclusions, contradictory advice, to refrain from offering prescriptions or recommendations. As Edward du Cann said, such as there are are inferential. And if you look at the compendium of views expressed in the Report they do on almost every issue appear to be facing both ways. They tell us that the money supply has been growing too quickly but that the financial squeeze is too tight. They are calling for intervention to bring down the level of the pound but they want tighter monetary control. They want public spending cuts but they don't want cuts that hurt the private sector. They want nationalised industry prices restrained but the Public Sector Borrowing Requirement reduced. And so on. It's difficult for them to come to conclusions and make recommendations and that I think is the shortcoming of the Report.

Interviewer: You sound, Chancellor, as if you think the Report hasn't been very helpful. But one point, when I asked Mr. du Cann whether he had any specific advice to offer to the Government, he said that perhaps the time had come to make a further cut in the interest rate. Do you see any prospect of that in the near future.

Chancellor: Well as you know I don't comment on the prospects for interest rate changes at any stage in this kind of way. But there again you see of course everyone wants to see lower interest rates but the implications of the Report are conflicting on that.

/ The section

The section which is by implication criticising the prematurity of the reduction we have made a few weeks back, and yet calling for further progress in the same direction. I think this is the anxiety that the Committee are offering no coherent alternative. They are feeling their way to what I hope will be a more constructive approach and I fear have tended to play down the good news - the great success we are having in the attack on inflation, and to add to the risk, which they themselves have identified, that Government may be knocked off course by political complaint. I would like to believe that as the Committee develops in its work they will help to sustain Government in the strategy to which they are offering no alternatives.

PA
(cf file)

MRS GILMORE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Middleton
Mr Bridgeman
Mr Britton
Miss Brown
Mr Burgner
Mr Cassell
Mr Dixon
Mr Evans
Mr Lavelle
Mr Monck
Mr Bottrill
Mr Aaronson
Mr Folger
Mr Ridley
Mr Cropper
Mr Cardona

Mr Ingham
Mr Lankester } No 10
Mr Vereker

MS 8/1

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PRIME MINISTER

You might like to glance through Annex A and Annexes C and D before Questions, since you may get some of the Select Cttee's charges thrown at you.

The Report itself is attached; Tim has sidelined some of the many awkward bits. MS 17/12

TREASURY SELECT COMMITTEE'S REPORT ON THE GOVERNMENT'S ECONOMIC POLICY: PRESS BRIEFING

I attach background briefing on the above which will be released publicly at a press conference at noon tomorrow (CFRs having been issued at 3.00 pm today). The brief reflects inter alia discussion with the Chancellor, the views expressed by the Financial Secretary, and various conversations with Mr Ridley. It is based on the draft text given to us in advance for factual vetting, subject to amendments we understand have subsequently been made, but will still need checking against the final report as it emerges.

2. The briefing contains:

Annex A: some general points about the Committee's overall approach and some of the more important individual points of substance. These are the main positive points to try to get over.

Annex B: material on the deficiencies of the Committee's remarks on forecasts.

Annex C: material on the Committee's treatment of monetary developments.

Annex D: A note on the Committee's treatment of competitiveness. (This includes useful material on the sterling appreciation that took place under Mr Healey rather than the present Government).

Annex E: some remarks (provided by Sir Ken Couzens) in the light of the recent staff report by the IMF team. This should be used with care and is primarily intended for use in a Ministerial speech or statement. It does not refer to the IMF report as such (we do not wish to set a precedent here) but it alludes to some of its content in order to contrast the omissions of the Treasury Committee's report with the broader approach of the IMF team who saw UK policies in their proper international context and gave appropriate credit for the Government's achievements on the inflation front. (NB: Mr Healey referred publicly in 1978 to the contents of the report of an IMF mission - Hansard col 1723-1726, 25 May 1978).

3. Most of the material is pitched fairly aggressively, which reflects, I think, the Chancellor's desired general approach. But equally the Chancellor saw the aggression as being more in sorrow than in anger that the Committee should see fit to adopt such a hostile, carping and unconstructive approach.

4. You may also like to be reminded of Mr du Cann's 26 November letter about the treatment of public service pay for cash limit purposes. It and the Chancellor's letter of 24 November were released to the press (copies of the correspondence are attached to this note). But there is little of real substance now left between the Committee and the Government in this area and there are no points for us to score off the Committee.

5. The material above should not, of course, be used until the CFRs are out this afternoon. Nor (to preserve the letter of the usual conventions) should we allow the impression to be derived that the briefing is in any sense the Government's formal response to the Committee's report. As the Chancellor agreed, we must consider later, in the light of press comments etc, whether it will be to the Government's advantage formally to respond. The report as such does not require such a response since there are no recommendations in it.

J B UNWIN
17 December 1980

RESTRICTED

A

Annex A

MAIN POINTS TO MAKE ON THE COMMITTEE'S REPORT AND THEIR GENERAL APPROACH

A COMMITTEE'S GENERAL APPROACH

1. The Report is largely unconstructive nit-picking about individual aspects of government policy and the current economic situation. There are no recommendations, let alone any alternative strategy to the government's broad approach: (the analogy of the surveyors report might be used here - plenty of detailed comments on bits of the structure, but nothing on the house as a whole).

2. The Report is not even coherent or internally consistent. For example, the Committee suggest that monetary conditions have been simultaneously too tight and too lax. Again there are complaints about increased public spending this year - a good part of which is due to the impact of the recession on the financial position of nationalised industries, yet elsewhere there is concern expressed about cutbacks in nationalised industry investment.

3. A major fallacy is the attribution of too much importance to government policy as a determinant of economic performance. The main reason for present failings is the cumulative impact of many years' poor industrial performance (under governments of both Parties), compounded now by the world recession (which the Committee effectively ignore) and the increase in oil prices. The Committee largely ignores these points.

4. The Committee remain obsessed by forecasting which (as the Chancellor and his predecessor have stressed many times) is a very inexact science. Too much is made of the - entirely unsurprising- fact that 8 months after the Budget the government now has a rather different forecast for the economic outlook. At the same time the Committee seek to put the gloomiest possible interpretation on recent events and continue to ignore the fact that the Treasury's forecast for 1981-82 is in many respects not far out of line with the views of reputable outside forecasters (see para 6 below).

5. This Report (and other aspects of the Committee's performance so far) must come as a disappointment to those [like the Chancellor himself] who saw in the new Select Committee system the potential for promoting a more informed and responsible debate about the real problems facing government. The Committee have not really progressed beyond the catalogue of observations in their Second Report 1979-80 (on the Budget and MTFS) and have not offered any new perspective or analysis.

B SOME INDIVIDUAL POINTS OF SUBSTANCE

(a) Path of output

6. In their commentary on the path of demand over 1981 the Committee apparently seek to leave the impression that output is likely to be much more depressed next year than the Industry Act forecast suggests. Naturally they offer no firm view of their own but they might at least have paid some attention to recent forecasts from respected outside bodies. Recent forecasts from eg Phillips & Drew, LBS and NIESR all agree in predicting no further fall in GDP during 1981 and indeed signs of the beginning of an upturn by the year end.

(b) Fiscal policy and 1981-82 FSBR

7. Throughout the report it is most unclear whether the Committee accept that the PSBR can properly be allowed to rise above trend in a recession. This is one of the key considerations for the 1981 Budget and it would have been helpful to the debate to have had the Committee's views. The government has made it clear that (as the MTFS provided) it believes the effects of the recession on the PSBR should be taken into account.

(c) Impact of recession on manufacturing

8. It is common ground that, partly because of unexpected strength of sterling [beyond government control], manufacturing has been particularly hard hit. The Committee say nothing on this that Treasury Ministers have not already told the House. Indeed as long ago as his October speech to the Party Conference and again in the 24 November statement the Chancellor stressed the need to ease the burden now falling on industry and indeed has already taken important steps in this direction (eg stock relief, weighting of NIC

contributions next year on to employees, measures to provide direct help to industry and employment).

(d) "Reentry" problems

9. The Committee claim that

(a) the shake-out of labour will mean fewer new jobs than usual when output recovers;

(b) pay pressures may grow again as profits recover

but (a) because they have not hoarded labour during the recession firms may well take on more new workers when the upturns comes;

(b) there is encouraging evidence of a new realism in the pay field and no reason to believe the lessons underlying it ("not pricing yourself out of a job") will not persist. The Committee's fears about a reversal in the current reduction in inflation have no foundation and can themselves only help to damage the prospects.

(e) Public expenditure in 1981-82

10. The Report says the Treasury cannot provide any additional information for 1981-82 beyond the policy changes announced on 24 November. This ignores the information given in the Chancellor's statement when he said "I now expect the volume of expenditure this year [1980-81] be some 1½% higher than expected at the time of the last White Paper" (col 313) and that "our aim is to keep the planning total for the volume of public expenditure in 1981-82 about 1% below the outturn now expected for the current year" (col 314). These two pieces of information give an order of magnitude for the planning total for 1981-82.

11. If necessary we can point out that, by simple arithmetic, the information given in the Chancellor's statement implies that the outturn for 1980-81 is expected to be between £79 billion and £79½ billion in 1980 survey prices (ie late 1979 prices) and that the aim for the planning total in 1981-82 is somewhere around £78-78½ billion.

12. The turnround in NIF Financing

The Committee states that its previously expressed fears about Government assumptions on improvements in nationalised industries' finances were well founded. The Committee fears were that in fact whether the very large improvement in NIs' financing would be achieved by <u>1983-84</u>. It is much too early to deliver a verdict. What is clear - as Mr Burns' evidence emphasised - is that, because of the severity and the nature of the recession, the NIs will need to borrow more in 1980-81 and 1981-82 than was expected when the White Paper (Cmnd 7841) was prepared. However, the White Paper went out of its way to stress the uncertainty attaching to the aggregate figures for the nationalised industries, especially for the later years. This emphasis remains relevant. Nonetheless, despite the increased EFLs published for 1981-82 the Government still anticipate a substantial improvement in the NIs' finances over the period covered by the White Paper, ie. to 1983-84.

1981-82 CASH LIMITS

24 Nov 1980

The Chancellor of the Exchequer, the Rt Hon Sir Geoffrey Howe, QC MP, has written today to the Rt Hon Edward Du Cann, MP, Chairman of the Treasury and Civil Service Committee. The text of the letter is as follows:

'My statement today covers certain general aspects of the 1981-82 cash limits relating to pay in the public services. To avoid any misunderstanding I am writing now to inform you and the Treasury and Civil Service Committee of two further specific points; and I am releasing this letter to the press.

First, the prospective increase in the paybill between financial years. In particular cash limits or Votes the actual percentage increase between 1980-81 and 1981-82 in the provision for pay will differ from the announced provision for the increase in earnings from due settlement dates. The number employed may change. In some cases the settlement date is not 1 April, so each financial year will include a period at the rate before and a period at the rate after the due settlement date. In addition, the increase in the provision for pay between 1980-81 and 1981-82 will be affected in some cases by settlements having been staged in 1980-81 with increases paid later than the usual settlement dates, but such staging not being repeated in 1981-82. This last will contribute some 1% to the increase in the total public service paybill between the two years.

Second, staging. The staging of awards has in the past resulted in a higher rate of pay being carried forward into subsequent years than otherwise would have been consistent with the cash limit. This erodes the effectiveness of the cash limit system and confuses the comparisons of the growth of earnings.

The Government therefore thinks it desirable for the future to avoid the delay or staging of awards, and will avoid it where it is itself the employer. If, this general policy notwithstanding, a public services employer were to delay or stage an award, the Government, when setting the relevant cash limits for the subsequent year, would not allow for the element of the award which had only been made compatible with the cash limit by such delay or staging.'

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET

From: the Rt. Hon. Edward du Cann, M.P.

CH/EXCHEQUER
REC. 27 NOV 1980
ACTION M. Bridgeman
COPIES TO CST
FST
Sir D. Wass
M Burns
M. Ryrie
Sir A. Rawlinson

M. Hansford
M. Bridgeman
M. Pagnier
M. Kemp
M. Unwin
M. Bottrill
Mrs Gilmore
Mrs Woods
M. Ridley
M. Cardona

HOUSE OF COMMONS
LONDON SW1A OAA

26 November 1980

Mr Folger
Mr Bush
F(SCT1)

27/XI

Thank you for your letter of 24 November about the way in which Civil Service pay is to be controlled in future.

Let me say at once that the Committee warmly welcomed the way in which you have gone a long way to implement the recommendations made in their Fifth Report. We had noted the Treasury's observations on the Fifth Report with some concern and we had intended to publish a further report which would have been critical of these observations. This will not now be necessary, and the Committee is glad that it is not. However, the Committee wished to make certain observations which we hope will be helpful to you. The Committee read your letter as meaning that a full explanation will be given at the relevant time explaining any difference there may be between the actual percentage increase between 1980/81 and 1981/82 in the provision for pay and the announced provision for increases in earnings from due settlement dates. As you point out there could be a number of reasons for any such differences and the Committee are convinced that it would be most helpful for a proper understanding of Government policy if the reasons for these differences were spelt out in full.

The Committee particularly welcomed your assurance that the Government will, in future, avoid the staging of awards which has given rise to confusion in the past and made control of total spending the more difficult. They are also glad to see that where a staged award is made by a public services employer, the Government, when setting the relevant cash limit for the subsequent year, would not allow for that part of the award which had been fitted into the previous year's cash limit by delaying or staging.

The third main point in the Fifth report stressed the difficulties which arose from splitting the provision for pay between the main Departmental Estimates and a global Estimate for increases arising from the annual pay settlement. With the suspension of pay research presumably no question of a split Estimate arises this year and the Committee trust that it will be avoided if and when pay research is resumed.

The text of this letter is being released to the Press.

The Rt Hon Sir Geoffrey Howe, Q.C.,M.P.,
Treasury Chambers
Parliament Street
S W1P 3AG

Annex B

ECONOMIC FORECASTS

GDP and demand

1. The Committee's report rightly stresses the uncertainties still remaining over economic developments in 1980 and points out that although the patterns of expenditure and output were somewhat different from those in the Budget forecast, the fall predicted for GDP this year was quite close to the 3% fall now expected.

2. We should stress the fallibility of the forecasts and the importance of not interpreting them too literally. Hence the reluctance on the part of the Chancellor and officials to be too precise. Of course any forecasts offer only a precarious foundation for firm expectations about future developments in the economy. The report singles out stockbuilding for comment and says there seems room for further substantial destocking during 1981. Table 2 of the Industry Act Forecast shows precisely this phenomenon: destocking of £1.6 billion in 1981, a larger fall in stocks than ever before recorded. Hence any suggestion that the Treasury output forecast is contingent on no further substantial destocking is just plain wrong. The slight recovery in GDP in the Treasury forecast already allows for further substantial destocking during 1981.

Manufacturing output

3. The Committee naturally draws attention to the large downward revision in the forecast of manufacturing output for 1980, some of which was due to the unexpected amount of destocking. There is a suggestion in paragraph 12 that the fall in output, in the economy and in manufacturing, is entirely a consequence of the rise in the exchange rate. Such a conclusion is fairly clearly false.

4. In their comments on 1981 manufacturing output the Committee take what can charitably be described as an over-literal interpretation of rounded forecasts: the broad picture is one of fairly flat output from the second half of 1980 and it is absurd to read too much into quarterly fluctuations.

Unemployment

5. It is worth stressing the uncertainties in this area, though the Committee's findings seem here as elsewhere to be on the gloomy side. For instance, paragraph 20 refers to the possibility that some of the recent rise in unemployment has been due to a shake-out of labour in manufacturing and draws the conclusion that this worsens the future prospect for employment. An alternative approach would be to stress that a shake-out resulting in improved competitiveness is favourable for long-term employment prospects.

Corporate sector and inflation

6. The Committee rightly stresses the uncertainty over recent figures, let alone over forecasts. Clearly the company sector is being squeezed. In consequence we are seeing a lower rate of increase, first of prices and now in wages. It is perfectly reasonable to point out, as the Committee does, that the reduction in the inflation rate has been achieved at the cost of a severe squeeze on profit margins, but the Committee could also have laid emphasis on the ensuing reduction in wage settlements.

PSBR

7. In the concluding paragraphs of their report, the Committee assert that the Treasury's estimate of the PSBR in 1981-82 is about 4½-5% of GDP at market prices. In fact such a figure, or range, is not contained either in the Industry Act Forecast or in the subsequent evidence to the Treasury Committee. On the 1981-82 PSBR the Industry Act forecast said simply:

> "... on the basis of the fiscal and monetary policy <u>assumptions</u> [emphasis supplied] used in constructing this forecast, the prospect is for some fall in the PSBR as a percentage of GDP." [ie to something below the estimate of 5% of GDP quoted for the 1980-81 PSBR]

We must not be drawn beyond that statement. But it is important to note that the Committee misrepresents the government's position on the 1981-82 PSBR. It has been made abundantly clear that a judgement on the 1981-82 figure will be taken in the Budget and consistently with the need to restrain monetary growth. So the Committee is tilting at a windmill with its questioning about consistency of the fiscal stance with a particular monetary growth target.

MONETARY DEVELOPMENTS

Inflation and Money

(i) The report comments that '... it is not easy to relate this success [in reducing inflation] to a close control of the money supply.

The point of this oblique remark is unclear. There are, as we have often pointed out, a number of factors which may influence the rate of inflation in the short term. The level of the exchange rate, and the trimming of margins on the part of companies in order to reduce stocks are two current examples. But there is considerable evidence, which we have drawn to the Committee's attention, attesting to the decisive impact, in the medium and long term, of the rate of growth in the money supply. If the Committee wishes to contest the existence of such a relationship it should say so.

Money Supply

(ii) The report also claims that the Treasury's explanations of the excessgrowth of £M3 are circular and argues that the Government has completely failed to control its one target variable.

Of course it is true that the counterparts discussed by Treasury officials at the hearing have the characteristics of an accounting identity. But the current account of the balance of payments and the PSBR are the counterparts of the private sector's demand for financial assets generally and changes in them do therefore tell us something about the demand for money. Movements in bank lending to the company sector reveal evidence of the financial imbalances between sectors. It is frivolous to describe the explanations offered for recent changes as 'saying that the money supply has risen because the money supply has risen'.

(iii) Paragraph 43 claims that 'there has been a suspension of the money supply numbers'.

We accept that the £M3 figure for 1980-81 will probably not come within the target range, although the Chancellor has explained the reasons why we expect growth to be lower in the latter part of the financial year. But the target is not suspended. At this stage in the financial year the Government's ability to influence the rate of growth is clearly limited, but the National Savings initiative, for instance, will be helpful to monetary control. We certainly hope to see the rate of growth move back towards the top end of the target range. The essential commitment remains to the MTFS and a new target consistent with that approach will be announced at the time of the Budget, together with any fiscal action needed to validate it.

(iv) Paragraph 44 appears to question the reasons for the 2% reduction in MLR announced on 24 November.

The reasons for the reduction were explained fully at the time. We observed a sizeable financial imbalance between the company and personal sectors, increasing signs of monetary stringency in the behaviour of the other aggregates, and rising real interest rates as inflation fell. It was right to take account too of the prospective slowing of monetary growth over the rest of the year, eg as bank lending slowed down (as it is now seen to have done in November). To have maintained MLR at 16% would have implied an increasingly restrictive policy.

Annex D D.

COMPETITIVENESS

Facts

1975=100

	IMF index of UK relative normalised unit labour costs	Relative export prices
1977	89.2	102.1
1978	96.5	108.4
1979	111.8	115.8
1980 Q1	126.1	123.3
Q2	134.0	127.2
Q3	140 *	131 *
Q4	147 *	135 *

* Treasury projections; precise figures not for public use

On the IMF measure, competitiveness has declined by 65% since 1977 (a low point): some 50% since 1978 and around 30% since May 1979.

Points to Make

(i) The Government has not sought this decline in competitiveness. Since 1978 two fifths of the decline is accounted for by the rise in the nominal exchange rate and three fifths by the faster rise in UK costs relative to costs abroad. So the decline owes as much or more to continuing to pay ourselves more than we can afford than to the rise in the exchange rate.

(ii) Although no one understands all the reasons for sterling's strength, there is little doubt that the main factor is our possession of North Sea oil in the face of continued uncertainty in the world oil market. High sterling interest rates may also be a factor, but their effect is smaller and much less certain, as demonstrated by recent events. Over the last six months the $/£ interest differential has shifted from 6% in sterling's favour to 6% in the $'s favour; while the £/$ exchange rate is now at much the same level as it was six months ago.

(iii) Of the rise in the exchange rate since 1976 more than half took place under Mr Healey's stewardship.

	rise in £/$ exchange rate
End October 1976 - 4 May 1979	31%
End October 1976 - 15 December 1980	47%

(iv) Despite the loss of competitiveness exports are keeping up remarkably well, and there are no signs of a surge in imports. The current account surplus is running at record levels, totalling £2.3 billion over the six months up to November.

(v) For the future there are factors that may help to ease the strength of sterling to set against those that have been supporting it. The balance of payments figures show that capital outflows made possible by abolishing exchange controls are still accelerating; as UK interest rates fall these outflows may be swollen by increased overseas borrowing in the sterling market; and as countries such as Germany and Japan get their balance ofpayments back into better shape some of the relative attractions of sterling may diminish.

INTERNATIONAL CONTEXT AND IMF VIEWS

The Committee say in their Report that they have concentrated on developments in the economy in the 8 months since the Budget. They do rather seem however to fall into the error, not unknown among some economists, of writing as if the whole world consisted of the British Government and the British macro-economy, and that everything that happened to the latter was the result of the actions of the former.

2. For example, there is no recognition of the impact on our effective exchange rate of the Iran-Iraq war, of the uncertainties over Poland, of the development of the OPEC surplus and of the deficits of countries like Germany. There is no recognition of the development of the US recession since our March Budget. It is perhaps natural that, by contrast, the recent IMF mission at the time of its annual visit to the UK specifically took the point that we were seeking to achieve the control of inflation in an unfavourable world environment. But they stressed that they supported the objectives and broad thrust of our medium term strategy and agreed with our judgement that the control of inflation is necessary in Britain to establish the basis for sustained growth.

3. Similarly, the Treasury Committee's Report has little or nothing to say about the recent evolution of pay and its contribution to economic developments: indeed its references to pay are largely confined to some rather technical remarks about civil service pay in cash limited programmes. The Report discusses the squeeze on industry's profit margins as if this was the result of Government policy or miscalculation. The IMF mission on the other hand while welcoming the moderation in wage claims in the present round, said that a further deceleration of wage increases appeared to be indispensable before a significant recovery in profit margins and therefore in output could be expected, and expressed the hope that such a deceleration could be achieved without too much delay in both private and public sectors. They also endorsed the steps the Chancellor announced on 24 November as appropriate to a situation in which, in spite of the £M3 figures, monetary policy has proved to be tight, and in which action to correct the course of the PSBR was necessary.

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15 December 1980

EFFECTS OF INCREASED NATIONAL INSURANCE CONTRIBUTIONS ON PAY BARGAINING

The increased National Insurance Contributions payable by employees from next April, which you recently announced, and which are provided for in the National Insurance (Contributions) Bill, will have a significant effect on employees' take home pay and on the Tax and Prices Index; and we need to bear in mind the potential effects on future pay negotiations.

I attach some examples which have been sent to me by a company which has recently, and with some difficulty, negotiated settlements in the 7/8% range. As you will see the combined effect of tax and the new NI contributions will be to claw back about half of the negotiated increases. The changes bear most heavily on the craftsmen. In the case of example B the employee concerned will, as from April, take home only £7.62 of his gross increase of £16 a week. In other words over 52% of his pay increase is lost to him.

The company is worried that once the size of the claw back is fully understood by trade union officials and by individual employees, there will be pressure for the settlements to be re-opened. They also fear that it will be harder to negotiate single figure settlements in future. We may find these attitudes reflected more widely. You will no doubt remember that Sir Derek Ezra concluded before the result of the miners' ballot was known, that the result would be significantly affected by the announcement about increased NI contributions.

I am not, of course, suggesting that we should reconsider decisions already taken, or contemplate concessions on the Bill, unless we find ourselves obliged to do so by our own back benchers. But I am sure you will agree that we need to be very much aware of the potential effect on pay bargaining of the increased NI contributions; and to take it fully into account when considering any changes in personal taxation for the next Budget.

I am sending copies of this letter to Patrick Jenkin, to the other members of E Committee, and to Sir Robert Armstrong.

Yours
Tom

EXAMPLE A

CRAFTSMAN

Pension Fund member, Married, 2 Children, Tax Code 214H.

	Present	New
	£ per wk	£ per wk
Earnings	175	190
Employee NI contribution	7.59	10.65
Employee Tax	39.90	44.40
Company NI contribution	16.21	18.70

Basic wage increase	=	£8.15 per week	
Earnings increase	=	£15.00 per week	
NI increase	=	£3.06 per week	(£3.06)
Tax increase	=	£4.50 per week	
Net increase		£7.44 per week	

Company pays extra.	=	£2.49 per week	(£2.49)

(   ) increase due to Government NI changes

EXAMPLE B

CRAFTSMAN

Pension Fund Member, Married, 2 children, Tax Code 214H

	Present	New
	£ per week	£ per week
Earnings	200	216
Employee NI contribution	7.59	11.17
Employee Tax	47.40	52.20
Company NI contribution	16.21	19.62

Basic wage increase	=	£8.15 per week	
Earnings increase	=	£16.00 per week	
NI increase	=	£3.58 per week	(£3.58)
Tax increase	=	£4.80 per week	
Net increase	=	£~~6.62~~ 7.62 per week	

Company pays extra = £3.41 per week (£3.41)

( ) increase due to Government NI changes

EXAMPLE C

GRADE B

Married Woman, Pension Fund Member, Tax Code 137L

	Present	New
	£ per week	£ per week
Earnings	65.50	70.54
Employee NI contribution	3.36	4.38
Tax	11.40	12.90
Company NI contribution	7.06	7.71

Basic wage increase	=	£5.04 per week	
Earnings increase	=	£5.04 per week	
NI increase	=	£1.02 per week	(£0.81)
Tax increase	=	£1.50 per week	
Net increase	=	£2.52 per week	

Company pays extra £0.65 per week (£0.19)

( ) increase due to Government NI changes

EXAMPLE D

GRADE D

Night shift, Pension Fund Member, Married Man, 2 children, Tax Code 214H

	Present	New
	£ per week	£ per week
Earnings	94.11	101.68
Employee NI contribution	4.57	6.01
Tax	15.60	18.00
Company NI contribution	9.69	10.57

Basic wage increase	=	£5.68 per week	
Earnings increase	=	£7.57 per week	
NI increase	=	£1.44 per week	(£1.12)
Tax increase	=	£2.40 per week	
Net increase	=	£3.73	
Company pays extra		£0.88 per week	(£0.18)

(   ) increase due to Government NI changes

EXAMPLE E

GRADE L MANAGER

Pension Fund member, Married Man, 2 children, Tax Code 214H

	Present	New
	£ per mth	£ per mth
Earnings	961	1047
Employee NI contribution	32.88	48.45
Tax	234.30	260.10
Company NI contribution	70.26	85.03

Earnings increase =	£86 per month	
NI contribution increase	£15.57 per month	(£15.57)
Tax Increase	£25.80 per month	
Net increase	£44.63 per month	
Company pays extra	£14.77	(£14.77)

( ) increase due to Government NI contribution changes

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PRIME MINISTER

To see pp 5-7 in particular

MS 28/11

ECONOMIC AFFAIRS - THE CHANCELLOR'S STATEMENT

It is hoped that Members may find the following notes useful for the debate on Economic Affairs on the last day of the Debate on the Address, Thursday, 27th November 1980.

Contents

Conservative Research Department,
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AB/CM/JV
26.11.80

The Chancellor's Statement

1. The Chancellor's statement on 24th November fell into five parts:-

i) The economic forecast, which the Chancellor is required by the Industry Act 1975 to publish twice a year.

ii) A statement on the roll-over of the monetary targets which he undertook in his March Budget to make in November.

iii) A statement on decisions reached on improvements in the system for controlling the money supply, following consultations between the Treasury and the Bank of England.

iv) Announcement of a 2 per cent cut in MLR and reference to measures to relieve unemployment and for industrial relief and support (some already announced).

v) Announcement of further economies in public spending, and revenue-raising measures for next year; and extension of index-linked national savings.

2. The Chancellor reaffirmed the Government's determination to maintain the thrust of the Medium Term Financial Strategy, published on Budget day in March. The Strategy had envisaged the possibility that events at home and abroad "might develop so as to produce a very different situation" to what was then anticipated:-

> "World trade could grow faster or more slowly than assumed; the supply response of the United Kingdom economy could be very different, with consequences for productivity and trade performance; oil and other commodity prices could show different movements; and the behaviour of earnings is always difficult to predict. Any of these outcomes, and many others, could significantly change the growth rate of the economy over the next few years, and hence the finances of the public sector.
>
> To maintain a progressive reduction in monetary growth in these circumstances it may be necessary to change policy in ways not reflected in the above projections. The Government would face a number of options for policy changes to achieve this aim, including changes in interest rates, taxes and public expenditure. But there would be no question of departing from the money supply policy, which is essential to the success of any anti-inflationary strategy".

Since its publication, events have so developed. The world recession has deepened faster and further than had been expected. The effects of the 130 per cent increase in oil prices since 1978 have been working through. In Britain, the high sterling exchange rate, resulting largely from our status as an oil producer, while it has contributed substantially to the reduction in prices, has also contributed to our loss of competitiveness - already seriously weakened by the 30 per cent

.../

faster growth in our wage costs, compared with our competitors over the last three years. Exports, although in total they have been maintained at a remarkably high level, are now beginning to reflect this disadvantage, as well as the slackening demand in world markets.

The objectives of Government economic policy are unchanged. They are to achieve a permanent reduction in the rate of inflation, and to create the conditions for a sustainable growth of output and employment.

Inflation is coming down rapidly - much faster than most people expected. Retail prices have risen by less than 1 per cent in each of the last six months and wholesale prices have risen more slowly still. The rate of inflation by the end of next year is expected to be not far above single figures.

The long-term leading indicators have for the past year pointed to the lowest point of the recession being reached at the end of this year or early next year. There are now signs that the turning point may be near. De-stocking, which has been the main cause of the sharp fall-off in orders, is probably nearly complete. Even the recent gloomy CBI forecast indicated a levelling off in the rate of decline of orders.

3. Monetary Targets

The Chancellor has decided to retain the 7-11 per cent target for the annual growth in M3 set out in the MTFS last March until next year's Budget statement. The target has been overshot in recent months, and the money supply figures have been grossly increased by the unwinding of the distortions caused by the 'corset' control since its removal in June. The Chancellor predicted that the movement of the public sector into surplus during the remainder of the financial year, and the indications that private sector borrowing may be levelling off will result in a much slower rate of growth in the money supply during the coming months .."The excess will certainly be less than the figures so far suggest".

4. Minimum Lending Rate

Ministers have repeatedly emphasised that the reduction of interest rates was a matter of high priority, as soon as it was safe to reduce them. The probable decline in the growth of M3 and the wider monetary aggregate expected in the new year, and the fact that the underlying rate of inflation is now well below the current level of short term interest rates, makes it possible now to cut MLR from 16 to 14 per cent.

5. Methods of controlling the money supply

The Chancellor said:-

> "The Treasury and Bank of England have completed the consultations arising from the Green Paper on methods of monetary control published last March. As a result between now and the Budget a number of improvements will be set in hand.... First, detailed consideration of new prudential arrangements for the banks will be brought to

.../

a conclusion so that the reserve asset ratio, which has complicated monetary control, can be phased out. Second, the Bank of England will develop changes in its open market operations and last resort lending - in ways that will allow the market a greater role in the determination of the structure of short-term interest rates. Third, we are considering the future of the clearing banks' cash ratio and also collecting and publishing an additional series for banking retail deposits. These steps are desirable in their own right. They would be consistent with a gradual evolution towards a monetary base system, and will help us to judge how far such a system would contribute towards our medium-term monetary objectives".

6. Special Employment Measures

Details given by Mr. Prior on 21st November are described in a separate CRD brief (PEPG (80) 7). The Chancellor announced that provision for selective assistance for investment and support for industrial research and development was to be increased by £50 million next year. Part of the cost of these measures will be balanced by the substantial reduction in our net contribution to the European Community, with £650 million next year.

7. Public expenditure and the PSBR

The Chancellor said that his aim was to keep the planning total for the volume of public expenditure for 1981-82 about 1 per cent below the expected outturn for the current year. This, largely as a consequence of the recession, would now be some 1½ per cent higher than was expected at the time of the White Paper in March. Excesses that emerged over this year's cash limits would be fully offset by reductions in the corresponding cash limits for 1981-82. The borrowing requirement for this year is likely to be £11½ billion instead of £8½ billion forecast in the Budget. But the high level of public sector borrowing in the early part of this year was likely to fall off; the public sector was expected to move into surplus in the new year.

8. Public Expenditure Cuts

Defence expenditure will be about £200 million less in 1981-82 than was allowed for in the March White Paper - it will grow by some 2½ per cent this year and next.

Local authority spending is intended to be 3 per cent less in volume that the level planned for this year; and the Rate Support Grant is to be calculated to provide less than the present 61 per cent of the reduced volume of expenditure. As already announced the RSG will provide for pay increases of 6 per cent.

Cash limited central Government spending apart from health is being cut by 2 per cent.

Social security benefits: prices have risen, it is estimated, by about 1 per cent less in the year to November than was allowed for when the increase in pensions paid this month was calculated last March.

..../

Legislation is therefore to be introduced to deduct this 'extra' increase from next spring's uprating - thus maintaining the value of the pension over the two years taken together. Public service pensions will be treated inthe same way. (Please see below the note on social services).

9. Revenue changes

The employees' National Insurance contributions are to be increased by 1 per cent: ¼ per cent to take account of the need to meet the higher cost of benefits; ¼ per cent to increase the health element in the contribution; and ½ per cent to reduce the Treasury's 18 per cent contribution to the National Insurance Fund to 14½ per cent. The yield will be about £1 billion in a full year; the increase will be levied on earnings between £27 to £200 a week (instead of £23 to £165 as at present). It was right, the Chancellor said, that those in work should bear a larger share of the cost of benefits paid to those unemployed.

Tax on petroleum: a new supplementary tax is to be introduced in next year's Finance Bill, to take effect from the beginning of next year. It will be levied on oil fields in production whether or not they are yet liable to PRT, probably at a rate of 20 per cent, to be deductible in calculating PRT and Corporate Tax. It is expected, with some changes in PRT reliefs, to yield £1 billion in 1981-82.

Savings eligibility for the very attractive index-linked 'Granny bond' certificates are to be extended, to attract some £3 billion into national savings next year.

10. Nationalised Industries

The trading position of the nationalised industries has deteriorated as a result of the recession. They have been required to make economies totalling more than £¾ billion. Even so, their external financing limits next year will be £620 million above the total estimated last March.

Economic Forecast: an extract is attached below.

11. SOCIAL SERVICES AND THE CONSERVATIVE GOVERNMENT

The Conservatives have been in power for less than 20 months and have been confronted with grave public expenditure constraints. Nonetheless we have safeguarded those in need, we have given extra help to a number of groups and we have protected the National Health Service.

Of course, with limited cash, we have not been able to protect all benefits against inflation, for this depends on a stronger economy, but the measures listed below that we have taken in the field of social services are ones that we can all be proud of and which demonstrate our concern and compassion.

The Elderly

* pensions were increased last November by almost 20 per cent, which was higher than the corresponding rise in prices and represented a small increase in real value. Pensions are bieng raised by 16½% this November, which is likely to be ahead of prices (in the year to October 1980 prices rose by 15.4%) and will improve their standard of living still further.

* all pensioners were given a £10 Christmas Bonus last year and will receive it again this year.

* over 1½ million supplementary pensioners(i.e. dependent on supplementary benefit) will receive considerable extra help with heating costs this November. The basic heating addition will be raised by almost half from 95p to £1.40 pw, and will also be given automatically to all supplementary pension householders who are aged 70 or over.

* in addition, supplementary pensioners and pensioners on rent and rate rebates will be eligible for higher home insulation grants amounting to 90% of the costs up to a limit of £90.

* 30,000 pre-1950 war widows have been given a pension to which they were not previously entitled.

* war widows' pensions have been exempted from income tax.

* pensions with small savings income or private pensions have been able to keep more of their own income because of the cut in the basic rate of income tax from 33 per cent to 30 per cent.

The disabled

* the attendance allowance was increased by nearly 20 per cent last November and will be raised this year by 16½%, which is likely to be ahead of prices

again.

* the mobility allowance was raised from £10 to £12 last November, and will go up to £14.50 this November.

* 15,000 disabled people aged 63-64 were phased into the mobility allowance last November, sooner than the Labour Government intended.

* the disabled will be able to claim the higher or long-term rate of supplementary benefit after one year, instead of after two years as at present.

One-Parent Families

* the child benefit addition, paid to the first child of one-parent families, was raised from £2 to £2.50 last November and will go up to £3 this November.

* family income supplement for those on low-incomes (about half the recipients are single parents) will also be raised by one third in November.

* at present the first £6 of weekly earnings by a single parent is disregarded for supplementary benefit purposes. The Government will now allow single parents on supplementary benefit to retain more than half their earnings up to £20 per week, so that they will not be discouraged from providing for themselves.

* the higher or long-term rate of supplementary benefit will be paid to single parents after one year instead of two as at present, also from this November.

* many one-parent families dependent on supplementary benefit will benefit from the increase in heating addition and in supplementary benefit rates for young children.

National Health Service

* hospital queues have fallen substantially under the Conservatives. Under Labour they rose by almost a quarter of a million to 752,000 in England alone by March 1979; however by March 1980* we had reduced this to 662,000 a fall of 90,000.

* the resources going into the Health Service have been fully maintained, as promised in our Manifesto. In the current financial year we will be spending some £11,900m on the NHS - more than in any of the five years of Labour Government in real terms.

* Health Service administration in England is being simplified by cutting out the Area tier and devolving

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* based on 95% return

power to local District Health Authorities. Our intention is to save some £30m pa in administrative costs, which will then be available for patient care.

* the Government has announced its intention of having smaller hospitals in the future and a consultation paper will be published soon on how this change of emphasis in hospital building might be achieved.

* under Labour there was much confusion about the role of volunteers, particularly during the widespread hospital strikes in the winter of 1979. The Conservative Government has made it clear that it will support any health authority that decides to make use of volunteers and has set out the actions whichshould be taken to deal with industrial disputes.

* pay-beds have been retained, rather than phased out as Labour intended, which will result in extra income for Health Service hospitals.

* other restrictions on private clinics and hospitals have been eased, which will help relieve the strain on the NHS.

Personal Social Services/Volunteers

* in the five years to 1983/4 proposed expenditure on the personal social services will total more in real terms than in the five years of Labour Government. (Between 1974/5 and 1978/9 £6414m was spent; between 1979/80 and 1983/4 expenditure will total £6679m. Source: Public Expenditure White Paper March 1980; all figures at 1979 survey prices).

* it is not always realised that voluntary organisations contribute more in the field of the personal social services than the local authority statutory services. The Chancellor therefore announced important tax concessions for charities, worth £30m pa, in his last budget - concessions which represent the biggest help for charities for fifty years.

* the Department of Health and Social Security has maintained in real terms its grants to voluntary organisations and has urged local authorities to do the same.

Public Expenditure Cuts

Under the Social Security (No.2) Act 1980 unemployment benefit, sickness benefit, injury benefit, maternity benefits and invalidity pensions are being raised this November by only 11½%, which is less than the rise in prices.

One reason forsingling out these benefits is that they are tax-free (unlike, say, the retirement pension or the widow's pension) and the Government will not be able to bring them into tax before April 1982. This tax free status confers an unexpected bonus on many recipients.

The Government has promised subject to the availability of resources, to restore the value of the invalidity pension when it is brought into tax.

The Chancellor has also announced that in November 1981 pensions and other benefits will be raised by one percentage point less than prices. However as this year there will be an unexpected "overspend" (i.e. most benefits are being raised by 16.5%, whilst prices in the year to October 1980 rose by 15.4%), the Chancellor's action will do more than ensure that the overspend in 1980 will be corrected.

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26.11.80

Extract from H.M. Treasury Economic Forecast (published on 24th November 1980).

12. ECONOMIC PROSPECTS

Introduction

15. This forecast takes account of the decisions on public expenditure and taxation announced by the Chancellor on 24 November. For 1981-82, tax receipts are projected on the conventional assumption that allowances, thresholds and specific tax rates are uprated in line with the growth of the RPI during 1980.

16. In addition to the National Savings initiative, a reduced rate of government borrowing and bank lending is expected in the course of the second half of the current financial year. Thus the forecast of underlying monetary growth over the target period of February 1980 to April 1981 is that it will come back towards the top of the 7-11% range. For 1981-82, the forecast assumes that monetary growth will be at the centre of the MTFS range of 6-10%.

17. It is assumed for the purposes of this forecast that the exchange rate in 1981 will be at a level similar to that in mid-November.

Inflation

18. In the current quarter, retail prices are likely to show an increase over a year earlier of around 15½%: 1% less than the Budget forecast. Over the past three months, and helped by some particularly favourable influences not all of which may persist, prices have been rising at little more than ½% a month. This lower trend seems likely to continue into next year, so that the year on year increase in the early part of 1981 should show another substantial fall. Thereafter much depends on the rise in costs. Earnings in the current pay round are assumed to rise by less than half the rate in the previous pay round, with earnings in the public services rising by less than in the rest of the economy. Other costs, especially imported materials and fuels, should continue to rise less fast than labour costs, though it is assumed that there are no further benefits on the sterling price of imports from a rising exchange rate. Profit margins have declined very sharply in 1980: the prospect for next year is highly uncertain, but margins may not decline as much again. The forecast is for a rise of 11% in retail prices between the fourth quarters of 1980 and 1981. There are however several ways in which single figure inflation could be achieved next year: such an outcome would be comfortably within the range of possible outcomes implied by the margin of error on the forecast.

World economy and UK trade

19. In the face of a 140% increase in the price of oil, activity in the industrial economies at first showed surprising resilience, growing by 3% in the year to early 1980. Since then a general slowdown has taken place. In the second quarter GNP fell in all the main economies except Japan. The drop was especially steep in the US, though there are now signs that the decline there has come to an end. Activity in the industrial economies is expected to remain weak in the second half of 1980 and early 1981, with a recovery starting around the middle of next year. In the face of stubborn inflation and, in some countries, a weak external position, most Governments are likely to continue following restrained fiscal and monetary policies.

20. The growth of UK export markets (world trade in manufactures, UK weighted) is expected to slow down substantially, from an estimated 8% in 1980 to possibly 3% or so in 1981, with a substantial margin of error in either direction. The surprisingly high figure for 1980 reflects partial information for the first half of the year. Moreover, markets which are relatively more important to the UK, in particular OPEC, have been the fastest growing.

21. The volume of UK exports of manufactures (less erratics) in the three months to October was 2% lower than the 1979 average. Some further decline is possible next year, in the context of slow growth in world trade and the continuing effects of past losses in competitiveness - working through both the supply of and demand for exports. While the consequences of large changes in competitiveness are extremely difficult to evaluate, evidence for this country and for other industrialised countries is consistent with the view that there are significant effects on trade, often with a considerable lag. Total exports, sustained to some extent by rising exports of oil and some other non-manufactured goods, are forecast to fall by 3% in 1981.

22. The fall in the volume of manufactured exports this year has been more than matched by the fall in imports: in the three months to October, the volume of manufactured imports (less erratics) was 9% less than the 1979 average, much of this fall reflecting de-stocking. Predictions of imports have proved notoriously fallible, but the judgement in this forecast is that the falling trend will soon stop: for 1981 as a whole, there may be little change in imports of goods and services.

23. The large surpluses on the current account in recent months reflect, in part, rapid de-stocking. If that lessens next year, and if adverse competitiveness effects continue to be felt, then the balance of trade in volume terms may tend to deteriorate but with a further improvement possible in the terms of trade, and with the benefit of the EC rebate, the current balance may remain in surplus.

Domestic demand and activity

24. The principal feature of the changes in demand in 1980 is the stock cycle: the immediate adjustment by firms has largely taken the form of cutting back on stocks. Whereas in 1979 stocks in total were built up by about £1½ billion, in 1980 they are being run down sharply. In the second half of 1980, other reductions in domestic demand - in consumers' expenditure, private investment and in some areas of public expenditure - are probably taking place. Next year may see less de-stocking, but a continuation of the fall in private and public fixed investment.

25. The real value of personal incomes has risen this year as a result of large increases in pay and the falling rate of inflation. Next year, with a further fall in activity and employment, with increased national insurance and health contributions, and with increases in some people's earnings falling short of the rate of inflation, real personal disposable income may well be lower than in 1980. But the savings ratio is likely to decline from its present high level, partly because of the usual lag between income and spending changes, partly because of the decline in the rate of inflation. Hence consumers' expenditure in 1981 may be close to its 1980 level.

26. Output in 1980, for the economy as a whole, is forecast to be 3% lower than in 1979. Within the total, manufacturing output may be 10% lower. The forecast of output in 1981 turns crucially on a very uncertain assessment of the second half of 1980, and on how much of the decline in output has been caused by de-stocking. The central forecast for 1981 is that, with a slower rate of de-stocking, there may be no further fall in output from the level in

the second half of 1980. This prospect is, however, extremely uncertain. It is quite likely that the bottom of the recession will be reached in the course of next year, with perhaps some recovery before the end of the year. For 1981 as a whole, GDP may be 1½% below the 1980 level; with manufacturing output 4% down. Output of North Sea oil and natural gas liquids is expected to have risen to around 80 million tonnes in 1980. Oil production next year is expected to be in the range 85-105 million tonnes, as forecast in the Report to Parliament by the Secretary of State for Energy, June 1980 (the Brown Book). Unemployment is at present rising rapidly. Further rises must be expected, though the flattening out in the path of output forecast for next year should contribute to a slower rate of increase in unemployment.

<u>The Public Sector Borrowing Requirement</u>

27. In the first half of 1980-81, the PSBR was £8 billion, seasonally adjusted. A much lower rate of borrowing is expected in the second half of the year, partly because of: the rebate on EC contributions, rising receipts of North Sea taxes and asset sales. The result is a forecast, still subject to a wide margin of error, of the PSBR in 1980-81 of £11½ billion or 5% of GDP at market prices. Of the upward revision to the forecast of the 1980-81 PSBR made at Budget time, much can be attributed to higher borrowing by local authorities and public corporations reflecting both higher than expected expenditure and the worsening of trading conditions. In the central government account, the main reason for higher borrowing is increased expenditure, including defence, in both volume and cash terms, much of the volume increase resulting from the effects of recession. The net change in revenue from Budget estimates is expected to be small as a result of offsetting effects from higher pay and from lower employment and output. North Sea oil and gas revenues in 1980-81, at current prices, seem likely to total about £4 billion, or 1½% of GDP at market prices.

28. For 1981-82, the continuing recession will tend to increase the PSBR. This should be more than offset by a combination of factors pointing in the opposite direction: by the effect of the

fiscal decisions announced on 24 November; by some improvement in the finances of public corporations as they continue to increase prices, mainly of energy, towards economic levels: and by a lower level of pay increases in the public services. After taking account of the proposed tax changes announced on 24 November, revenues from North Sea oil and gas in 1981-82 are expected to be in the range £4½-5 billion, at 1980-81 prices, a little higher than forecast at the time of the Budget.

29. The uncertainties over the estimated outturn for this year's PSBR are magnified in 1981-82. The 1980 FSBR indicated a margin of error for the year immediately ahead - which is no more than an average derived from past forecasts, and which by definition may therefore be exceeded - of £3 billion either way. At this stage, the margin of error on the 1981-82 PSBR is necessarily greater. On the basis of the fiscal and monetary policy assumptions used in constructing this forecast, the prospect is for some fall in the PSBR as a percentage of GDP.

Margins of error

30. Table 1 shows margins of error calculated from internal Treasury forecasts over the last ten to fifteen years. Two factors in particular, suggest that such past averages may understate the risks of being wrong in present circumstances. The first is the uncertainty over the response of inflation, and of the economy in general, to the present stance of monetary and fiscal policy. The second is the uncertainty over the amount and timing of trade and output responses to the past loss of trading competitiveness.

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24 November 1980

ECONOMIC PROSPECTS TO END- 1981

The Industry Act (1975) requires the Government to publish economic forecasts twice yearly. This press notice reviews economic developments so far this year and looks at the prospects to the end of 1981.

Summary

2. The UK economy is confronted by the need to bring about a major adjustment to a higher exchange rate, by the need to bring about further reductions in inflation and by the problems of recession in the world economy. In these circumstances, output and employment are liable to decline.

3. Progress on reducing inflation this year has been rapid. Next year, especially the early months, should see a further major reduction in the year-on-year rate of inflation from 15½% in the fourth quarter of 1980 to perhaps 11% in the fourth quarter of 1981. There has been a sharp fall in output and employment this year, as firms have reacted to large increases in domestic costs and to financial pressures. Next year, there may be no further fall in total output from the level in the second half of 1980.

4. Great uncertainties surround the prospects for the economy over the coming year. The figures in this forecast must be interpreted in the context of the large margins of error to which all forecasts are subject.

5. In the Government forecasts published a year ago, and at the time of the Budget, 1980 was foreseen as a year of recession and falling inflation. A poor trade performance, because of weak overseas demand and adverse competitiveness, was expected, together with tight monetary and fiscal policies (with both the money supply and the PSBR as percentages of GDP expected to decline). 1980 is now clearly emerging as a recession year, and the inflation rate is falling; yet it is domestic demand, more than trade, which has led the recession.

6. Government borrowing in the first six months of the current financial year was £8 billion (seasonally adjusted). This PSBR and a high level of bank lending were the main reasons why the rate of growth of the money supply, at 15% between February and October 1980, was well above expectation. A number of factors have contributed to pushing up the exchange rate, among them: inflows of OPEC funds, the growing value of North Sea oil, the uncertainties over the Gulf war, the turnround in the current account and high levels of nominal interest rates in the UK. The rising exchange rate has been accompanied by a faster growth in costs and prices in the UK than in most competitor countries and hence there has been a large and indeed unprecedented loss of competitiveness. On the basis of relative labour costs, the level of competitiveness in 1980 is estimated to be some 40-50% less favourable than in 1978. Of this change in competitiveness, around three-fifths has been due to UK unit labour costs increasing faster than those of our competitors and the remaining two-fifths to exchange rate appreciation.

7. Up until the early part of 1980, output and employment had been maintained, despite mounting cash flow problems for some companies squeezed by a high exchange rate and rapidly rising domestic costs. But around the turn of the year, and still more in the spring, many companies were finding their financial position much worse than expected, with future prospects gloomier, because of: a widespread acceleration of domestic costs; a rising exchange rate; and falling profit margins. The result was a concerted fall in orders from the second quarter of 1980, accompanied by attempts to get rid of stocks by cutting prices,

and by reductions in output and in employment. These tendencies can be seen most clearly in successive replies to the CBI enquiries, which relate to the industrial sector of the economy, worst affected by the recession:-

Percentage balances of ups and downs

	Firms working below capacity	Trend in output volume over next 4 months	Present volume of stocks too high	Trend in average prices of domestic orders
1980 January	63	- 11	15	65
April	70	- 14	26	56
July	76	- 41	36	33
October	84	- 31	33	20

8. Thus companies, particularly in the more exposed parts of manufacturing, but also in distribution and elsewhere, are now adjusting rapidly. The second half of 1980 is seeing a further large fall in employment and further destocking, with profit margins being cut again.

9. A combination of strong recessionary pressures and a high and rising exchange rate has limited firms' abilities to pass on higher costs to their customers. This squeeze on profit margins in the private sector has taken several percentage points off this autumn's level of retail and wholesale prices.

10. The rate of inflation over the last six months has been running well below the rate of around 15% shown by the usual comparisons of the retail and wholesale price indices with the same period a year earlier. For both wholesale and retail prices, the annual rate of increase over the six months to October was 8½%. Particularly in the case of retail prices, this figure understates the underlying rate of increase in prices, mainly because of favourable trends in seasonal food prices and the tendency of prices to rise sharply in the spring. A rough adjustment for these special factors might not add more than three percentage points to the 8½% figure - confirming a substantial deceleration in retail price inflation.

11. Many domestic costs have been slow to respond to the slowdown in inflation. Average earnings, for the economy as a whole, rose by 22% over the year to the third quarter of 1980, although the underlying increase in manufacturing was lower, at 18%. There are, however, clear indications of a major reduction occurring in the current pay round in both wage claims and settlements. Important contributory factors, reflecting both the current position and future expectations, are: the Government's monetary and fiscal policies, companies' reduced ability to pay, the reduction in the rate of inflation and higher unemployment.

12. The reduction in price inflation ahead of a reduction in pay increases has led to a substantial rise in real earnings, for those in employment, over the past year. But with employment falling and some other elements in personal incomes rising more slowly than pay, the real value of consumers' disposable income over the past year has risen slowly. Nevertheless, and perhaps partly in response to the rise in inflation last winter and to the subsequent rise in unemployment, the personal sector's savings ratio has tended to rise, leaving personal consumption close to last year's level. Thus the burden of the recession has fallen mainly on the company sector and on the unemployed, but not in general on those in employment.

13. The trade balance this year has been much better than expected at the time of the Budget: a major fall in the volume of imports, induced by the sharp decline in industrial activity, has far outweighed the effects of poor competitiveness. Exports of manufactures in the first ten months of this year were close to the 1979 average. It seems likely that over much of this period the volume of world trade was well up on 1979: the loss of UK share this year, measured in volume terms, may be attributed mainly to a lagged response to worsening competitiveness. Imports of manufactures were 10% lower in the three months ending October than in the three months ending July, a downward trend that probably owes much to heavy de-stocking throughout the economy. The balance of payments is continuing to benefit from a surplus on invisible items, mainly reflecting high private service credits, partly offset by transfer debits. In total the current account is estimated to have been in surplus of over £1 billion in the first ten months of the year.

14. By the third quarter of this year, total output in the economy was perhaps 4% below the average of 1979, with a larger fall in industrial output. Partly in consequence, but also because of companies' needs to limit the deterioration in their cash and liquidity positions, employment has been falling, with a particularly rapid fall in manufacturing. Unemployment, in turn, has risen exceptionally quickly over the last six months. By acting promptly to reduce their labour forces and their stocks, companies this year have limited the extent of the rundown in their liquidity position. Even so, the net borrowing requirement of industrial and commercial companies in the first half of 1980 was exceptionally large.

ECONOMIC PROSPECTS

Introduction

15. This forecast takes account of the decisions on public expenditure and taxation announced by the Chancellor on 24 November. For 1981-82, tax receipts are projected on the conventional assumption that allowances, thresholds and specific tax rates are uprated in line with the growth of the RPI during 1980.

16. In addition to the National Savings initiative, a reduced rate of government borrowing and bank lending is expected in the course of the second half of the current financial year. Thus the forecast of underlying monetary growth over the target period of February 1980 to April 1981 is that it will come back towards the top of the 7-11% range. For 1981-82, the forecast assumes that monetary growth will be at the centre of the MTFS range of 6-10%.

17. It is assumed for the purposes of this forecast that the exchange rate in 1981 will be at a level similar to that in mid-November.

Inflation

18. In the current quarter, retail prices are likely to show an increase over a year earlier of around 15½%: 1% less than the Budget forecast. Over the past three months, and helped by some particularly favourable influences not all of which may persist, prices have been rising at little more than ½% a month. This lower trend seems likely to continue into next year, so that the year on year increase in the early part of 1981 should show another substantial fall. Thereafter much depends on the rise in costs. Earnings in the current pay round are assumed to rise by less than half the rate in the previous pay round, with earnings in the public services rising by less than in the rest of the economy. Other costs, especially imported materials and fuels, should continue to rise less fast than labour costs, though it is assumed that there are no further benefits on the sterling price of imports from a rising exchange rate. Profit margins have declined very sharply in 1980: the prospect for next year is highly uncertain, but margins may not decline as much again. The forecast is for a rise of 11% in retail prices between the fourth quarters of 1980 and 1981. There are however several ways in which single figure inflation could be achieved next year: such an outcome would be comfortably within the range of possible outcomes implied by the margin of error on the forecast.

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19. In the face of a 140% increase in the price of oil, activity in the industrial economies at first showed surprising resilience, growing by 3% in the year to early 1980. Since then a general slowdown has taken place. In the second quarter GNP fell in all the main economies except Japan. The drop was especially steep in the US, though there are now signs that the decline there has come to an end. Activity in the industrial economies is expected to remain weak in the second half of 1980 and early 1981, with a recovery starting around the middle of next year. In the face of stubborn inflation and, in some countries, a weak external position, most Governments are likely to continue following restrained fiscal and monetary policies.

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24. The principal feature of the changes in demand in 1980 is the stock cycle: the immediate adjustment by firms has largely taken the form of cutting back on stocks. Whereas in 1979 stocks in total were built up by about £1½ billion, in 1980 they are being run down sharply. In the second half of 1980, other reductions in domestic demand - in consumers' expenditure, private investment and in some areas of public expenditure - are probably taking place. Next year may see less de-stocking, but a continuation of the fall in private and public fixed investment.

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the second half of 1980. This prospect is, however, extremely uncertain. It is quite likely that the bottom of the recession will be reached in the course of next year, with perhaps some recovery before the end of the year. For 1981 as a whole, GDP may be 1½% below the 1980 level; with manufacturing output 4% down. Output of North Sea oil and natural gas liquids is expected to have risen to around 80 million tonnes in 1980. Oil production next year is expected to be in the range 85-105 million tonnes, as forecast in the Report to Parliament by the Secretary of State for Energy, June 1980 (the Brown Book). Unemployment is at present rising rapidly. Further rises must be expected, though the flattening out in the path of output forecast for next year should contribute to a slower rate of increase in unemployment.

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fiscal decisions announced on 24 November; by some improvement in the finances of public corporations as they continue to increase prices, mainly of energy, towards economic levels: and by a lower level of pay increases in the public services. After taking account of the proposed tax changes announced on 24 November, revenues from North Sea oil and gas in 1981-82 are expected to be in the range £4½-5 billion, at 1980-81 prices, a little higher than forecast at the time of the Budget.

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Margins of error

30. Table 1 shows margins of error calculated from internal Treasury forecasts over the last ten to fifteen years. Two factors, in particular, suggest that such past averages may understate the risks of being wrong in present circumstances. The first is the uncertainty over the response of inflation, and of the economy in general, to the present stance of monetary and fiscal policy. The second is the uncertainty over the amount and timing of trade and output responses to the past loss of trading competitiveness.

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TABLE 1: ECONOMIC PROSPECTS TO END 1981

	Percentage changes 1979 to 1980	Percentage changes 1980 to 1981	Margins of error⌿⌿ for 1981 forecast per cent
A. OUTPUT AND EXPENDITURE AT CONSTANT 1975 PRICES			
Gross domestic product (at factor cost)	- 3	- 1½	1½
Consumers' expenditure	0	- ½	1½
General Government expenditure on consumption and investment	- 1	- 2	1½ ⌿
Other fixed investment	½	- 4	4 *
Exports of goods and services	1	- 3	3½
Change in stockbuilding as a percentage of GDP	- 4	1	1
Imports of goods and services	- 3	0	2½
B. BALANCE OF PAYMENTS ON CURRENT ACCOUNT	1980	1981	
	£ billion	£ billion	£ billion
	2	2	2
C. RETAIL PRICE INDEX	Percentage changes 4th Quarter 1979 to 4th Quarter 1980	Percentage changes 4th Quarter 1980 to 4th Quarter 1981	Per cent
	15½	11	3

⌿⌿ The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on government forecasts, notably in November 1978 (see Economic Progress Report Supplement or Economic Trends No. 301, November 1978). The calculations for the constant price variables are now derived from internal Treasury forecasts made during the period June 1965 to October 1978. For the current balance and the retail price index forecasts made between June 1970 and October 1978 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

⌿ This margin applies to general government consumption only.

* This margin applies to private sector investment only.

TABLE 2

CONSTANT PRICE FORECASTS OF EXPENDITURE, IMPORTS AND GROSS DOMESTIC PRODUCT (1)

£ million at 1975 prices, seasonally adjusted

	Consumers' Expenditure	General government expenditure on goods and services: Final Consumption	Fixed Investment	Total	Other fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	Less imports of goods and services	Less adjustment to factor cost	Plus statistical adjustment	GDP at factor cost	GDP index 1975 =100
1978	68100	23850	3550	27400	17300	32000	850	145650	31750	11950	0	101950	108.4
1979	70800	24350	3350	27700	17150	32900	1600	150150	35250	12350	700	103250	109.8
1980	70800	24550	2850	27400	17250	33200	-2650	146000	34200	12500	950	100250	106.6
1981	70300	24550	2300	26850	16550	32250	-1600	144350	34250	12250	950	98800	105.1
1978 First half	33600	11850	1850	13700	8750	15850	500	72400	15750	5900	-100	50650	107.7
Second half	34500	12000	1700	13700	8550	16150	350	73250	16000	6050	100	51300	109.1
1979 First half	35650	12100	1650	13750	8400	16050	1000	74850	17250	6300	350	51650	109.8
Second half	35150	12250	1700	13950	8750	16850	600	75300	18000	6050	350	51600	109.8
1980 First half	35700	12250	1500	13750	8700	16900	-500	74550	17750	6350	550	51000	108.5
Second half	35100	12300	1350	13650	8550	16300	-2150	71450	16450	6150	400	49250	104.8
1981 First half	35200	12300	1200	13500	8300	16250	-1300	71950	16900	6150	450	49350	105.0
Second half	35100	12250	1100	13350	8250	16000	-300	72400	17350	6100	500	49450	105.2
ANNUAL PERCENTAGE CHANGES													
1979-78	4	2	-5½	1	-1	3		3	11	3½		1½	
1980-79	0	1	-15	-1	½	1		-3	-3	1		-3	
1981-80	-½	0	-19½	-2	-4	-3		-1	0	-2		-1½	

(1) GDP figures in the table are based on 'compromise' estimates of gross domestic product.

Note - Figures in £ million are rounded to £50 million. Percentage changes are calculated from unrounded levels and then rounded to 0.5 per cent. The GDP index in the final column is calculated from unrounded numbers.

Prentice Econ Pol

THE ECONOMIC STRATEGY

Objective

The Chancellor's statement on 24 November has naturally aroused considerable public interest not only in the short term measures, but in the whole direction of the Government's economic policies. It is important to reaffirm that the fundamental objectives are unchanged, and that the Government are working in the framework of a coherent strategy, rather than reacting to problems as they arise. In particular, the Government are determined to maintain the thrust of the medium term financial strategy set out in the Financial Statement at the time of the Budget. This note is therefore designed for use by Ministers in all their speeches, broadcasts and writing this week and in the weeks to come.

Presentation

The objectives of Government economic policy are unchanged. They are to achieve a permanent reduction in the rate of inflation, and to create the conditions for a sustainable growth of output and employment.

In order to achieve these objectives, the Government published, at the time of the last Budget, a medium term financial strategy. The key elements in that strategy were control of the money supply, and a progressive reduction in public expenditure.

We said that the annual growth of money supply would be reduced to about 6 per cent in 1983-84; and we suggested some ranges for annual growth between now and then. There is no doubt that, partly because of technical distorting factors associated with the removal of the "corset" imposed by the previous administration, so far there is more money in the system than we intended. But we are confident that monetary growth will come down in the New Year; and we intend to take steps in the Budget to ensure that the thrust of the strategy is maintained. The Chancellor's announcement included new steps to make

/the technical

the technical control of monetary growth more effective and to ensure that fiscal policy next year is consistent with our objectives.

And we said that public spending would be substantially reduced over the life of this Parliament, rather than increased as our predecessors had planned. As the Chancellor indicated on Monday, it will still be lower next year than this, although the fall from the earlier plans will not be quite as much as we had intended. That is in large due to the worst international recession since the war, from which Britain is suffering particularly badly. At such a time considerable elements of public spending, such as social security payments and the borrowing needs of the nationalised industries, are bound to rise. But, even allowing for this, the volume of public expenditure will still be lower next year than this.

Despite these difficulties over the money supply and public spending - and let us be frank about them, the difficulties have been more severe than we expected - we are making good progress towards our objectives.

Above all, inflation is coming down rapidly - much faster than most people expected. Retail prices have risen by less than 1% in each of the last six months and wholesale prices have risen more slowly still. We expect the rate of inflation by the end of next year to be not far above single figures.

Pay settlements have moderated substantially. The figures published last week, of the increase in average earnings in the year ending in September, do not at all reflect the new climate of realism we have seen this autumn. In fact, the CBI estimate that a clear majority of the settlements in manufacturing industry this pay round have been in single figures. As for the public sector, we have told local authorities that we are making available only enough money to finance a 6% increase in their pay bills; and the Prime Minister has confirmed that the rest of the public service will be subject to the same sort of financial discipline.

/The Chancellor's

The Chancellor's statement was not a "mini-budget", but an indication of some of the decisions the Government have taken affecting the next Financial Year. The final Budget judgement will not of course be made until next spring; but the Government are determined to keep the amount of public borrowing next year within reasonable limits, so some action has been taken now which will enable us to raise revenues. We have chosen employees National Insurance Contributions, and an additional tax on petroleum revenues, because they do not affect the group which have suffered most from the recession - the unemployed. It is right that those who are fortunate enough to be in employment should bear some of the burden of looking after the unemployed.

In the circumstances it would be irresponsible to contemplate a large reduction in interest rates - as indeed the CBI have acknowledged. But in view of the measures the Chancellor has announced, we have been able to give the stimulus to output and employment that we have always said we would when the time was ripe, by bringing interest rates down a full 2%.

The Outlook

The way ahead is not an easy one. The recession will continue this year and well into next. Unemployment is bound to rise still further. Living standards are bound to fall, even for those who are still employed. Nevertheless over a two year period the real value of pensions will have been maintained.

But when the upturn comes - and this recession, though deeper than others, will like all recessions end in a period of growth - the conditions for a sustainable period of increasing production and increasing employment will be there. Above all, inflation will simply not be let loose again.

Responsible pay bargaining isn't just a sacrifice that everyone

/is being asked

is being asked to make this time round. It is an essential ingredient of our ability to seize the opportunity that the end of the recession will bring. Never again must people generally expect to be paid more and more pounds carrying less and less purchasing power. Stable prices, more jobs, and increased prosperity are within our grasp if we don't let greed overcome commonsense.

Paymaster General's Office
Privy Council Office
68 Whitehall
LONDON SW1

24 November 1980

ECON POL - Strategy Pt 7

Prime Minister

This seems alright.

Do you have any comment?

12

Copied to Public Exp: Pt 12

Mr Hodgson
Mr Vinter

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

See B.9.

PRIME MINISTER

PUBLIC EXPENDITURE

At Cabinet yesterday, I undertook to clear with the colleagues directly concerned the references in my statement to public expenditure.

..... 2. I now enclose the present draft of that part of my statement which refers to public expenditure. I also enclose the summary of changes to be circulated in the Official Report. The latter has been cleared at official level, subject to one point. I should be grateful to know during the course of Friday whether you, or any other members of the Cabinet to whom I am sending a copy of this minute, have any comments on the drafts.

3. The one outstanding point is the way in which we treat the increase in the EFLs for nationalised industries, but I am sure that can be resolved satisfactorily bilaterally between myself and the Secretary of State for Industry, and I need not trouble you and the others with it.

4. Immediately after the statement I propose to write to Edward du Cann, as Chairman of the Treasury and Civil Service Department Committee, about the treatment of pay in cash limits. This caused a good deal of misunderstanding between

SECRET

us and the Committee last year, so I want to make what we are doing absolutely clear to the Committee from the outset. ...... I enclose a draft of the letter which I would send to Mr. du Cann, and put out in a Press Release at the same time as the other material.

5. I am sending copies of this minute to the other members of the Cabinet, to the Minister of Transport and to Robert Armstrong.

Bwiggins

for (G.H.)

20 November 1980

(Approved by the Chancellor and signed in his absence)

Public Expenditure

As hon members will know, the PSBR during the first half of 1980-81 is estimated to have been about £8½

B1. I expect the PSBR to be much lower in the second half of the financial year, but it could be around £11½ bn for the year as a whole. [Much] of this is due to the effect of the recession, particularly on public expenditure.

B2. We have reviewed public expenditure plans for 1981-82. In conditions of continuing recession in the UK, some increases in expenditure arising from the recession must be expected and planned for. However, the total increase in expenditure and in public borrowing must be consistent with the medium term strategy and with a continued reduction in inflation. That is essential for a resumption of sound sustainable growth.

B3. It is realistic to assume a higher level of spending on unemployment and other benefits this year than allowed for in the White Paper of last March. The changes in trading conditions are reflected in the external financing limits for the nationalised industries for 1981-82 which, excluding steel, are being announced separately [today]. These industries are being required to secure substantial economies.

B4. My rhf the Secretary of State for Employment announced last week extension of the special employment measures which will cost nearly £250 million next year. The Government have also decided to increase the provision for selective assistance for investment and support for industrial research and development at a cost of £50 million next year. These amounts, and the other public expenditure changes I shall mention, are in the 1980 survey prices at which the decisions have been taken - that is broadly the prices of a year ago.

B5. In view of these increases, we must now plan to cut the volume provision for the majority of spending programmes. We must also restrict the cost, and so the cash requirements, of the public sector. Our aim is to hold the planning total for the volume of public expenditure in 1981-82 below the outturn now expected for 1980-81. The latter is some £[1] billion higher in volume than envisaged at the time of the last White Paper. I am publishing in the Official Report [and making available in the Vote Office now] a summary of the effect on expenditure programmes in 1981-82 of these decisions. Details of these changes, and of the changes in the provision for later years, will be set out in the public expenditure White Paper to be published at the time of the Budget.

B6. I should mention some of the main changes. We must, like some of our other NATO allies, adjust the rate of growth of our defence expenditure. Planned expenditure in 1981-82 will now be £200 million less than allowed for in the last White Paper. This will be nearly 8% higher than the level achieved in 1978-79.

B7. In broad terms, we shall be seeking a 3% reduction in the volume of local authority current spending compared with the level we planned for this year. We also propose to calculate the Rate Support Grant on the basis of providing a lower percentage of the reduced volume than the 61% (for England and Wales) in recent RSG settlements. My rhfs the Secretaries of State for the Environment, Scotland and Wales will be consulting their local authority associations on these proposals before the RSG settlements next month.

B8. In 1980 prices have increased less than we allowed for when we decided on the uprating of social security benefits for this November. There will accordingly be some increase in real value of benefits. We intend that the increase in retirement pensions and other benefits in 1981 will be such that the excess adjustment over prices, estimated at one percentage point, is not carried forward into future years. This will maintain the real value of the retirement pension over time. Public service pensions will be treated in the same way. Any further action on index linked pensions will follow the report of the Scott Enquiry. A decision on child benefit uprating will be taken at the time of the Budget. We have also decided that the earnings rule limit will remain unchanged.

B9. But the cost of public expenditure programmes, especially pay, is as important as volume. It is essential to our fiscal policy, and fair, to look for a much lower growth in public service earnings in the coming year than in the recent past. It has already been announced that the Rate Support Grant limit will allow for a 6% annual increase in earnings from due settlement dates in the current pay round. It

Please look at drafting? This looks like 6% on each person's earnings will provide for an increase in prices other than pay of 11% between the average levels for 1980-81 and 1981-82. Expenditure in other parts of the public services will be subject to broadly the same financial disciplines.

DRAFT (3rd of 20 November)

TEXT FOR CIRCULATION IN THE OFFICIAL REPORT

SUMMARY OF PUBLIC EXPENDITURE POLICY DECISIONS

A. Volume

1. The changes in expenditure programmes for 1981-82 due to policy decisions since the March Public Expenditure White Paper (Cmnd 7841) are:

	1981-82 £m at 1980 Survey Prices(1) (3)	
Nationalised Industries		
Increases in EFLs (other than for British Steel) including revised provision for shortfall		+620
Other policy increases(2)		
Special employment measures	+245	
Industrial support	+ 51	
Industry (other)	+ 10	
Health (withdrawal of some proposals for new charges)	+121	
Civil superannuation (accelerated retirement of civil servants)	+ 64	
Trade	+ 21	
		+510
EC refunds agreed on 30 May 1980		-650
Other significant policy changes:(2)		
(i) Local Authority Current Expenditure (England) - reduction by about 3% instead of 2% from planned level for 1980-81	-165	
(ii) Further changes in Departmental programmes (excluding elements of local authority current expenditure included in (i))		
Agriculture Departments	- 36	
Department of Employment	- 25	
Department of Transport	- 21	
Department of Environment	-158	
Home Office	- 17	
Department of Education and Science	- 52	
Office of Arts & Libraries	- 10	
Department of Health & Social Security (health and personal social services)	- 25	
(iii) Other Departments		
Defence	-200	
Foreign & Commonwealth Office	- 16	
Export Credits Guarantee Department	-166	
Department of Health & Social Security (social security)	- 66	
Scotland, Wales and N. Ireland (including changes to local authority current expenditure in Scotland and Wales)(4) (about)	-100	
Other (about)	- 15	
		-1,070

/ Footnotes - see next page

2. The changes take account of the salary savings expected in 1981-82 from the progressive reduction in Civil Service numbers to 630,000 by 1984.

3. The list does not include changes where the exact amount will be decided later eg British Steel and Child Benefit. Nor does it include the estimating adjustments, eg for demographic and economic factors, which will be made in the public expenditure White Paper to be published at the time of the Budget. The White Paper will include further details of the policy changes for 1981-82 and will set out the plans for 1982-83 and 1983-84.

B. Cash limits

4. Cash limits and Votes for expenditure other than pay will allow for an average level of prices in 1981-82 11% higher than the corresponding level in 1980-81.

5. The cash limits for the Rate Support Grant and for the Universities' Grant will include allowance for increases in earnings of 6% in annual settlements due before 1 August 1981, and also provisionally of the same amount for annual settlements due after that date. The allowance for pay in other cash limits, and Votes, will be so set that the pay of the relevant groups is dealt with broadly within the same financial disciplines. The outcome of settlements in particular cases will depend on the way in which the cash is allocated.

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(1) The figures are in the prices used for the 1980 Public Expenditure Survey, ie those of late 1979 or in some cases on average in 1979-80. In the case of transfer payments the definition of survey prices has been changed since the last public expenditure White Paper (Cmnd 7841) from the average of the financial year in which the survey takes place to the average of the last completed financial year.

(2) The increases and reductions shown include the net effect of various minor policy changes.

(3) Total changes are rounded to the nearest £5 million.

(4) The exact changes to Scottish, Welsh and Northern Irish programmes, in parallel with those to English programmes, have yet to be determined.

Draft Copy

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

November 1980

The Rt. Hon. Edward Du Cann, MP
House of Commons

1981-82 CASH LIMITS

My statement today covers certain general aspects of the 1981-82 cash limits relating to pay in the public services. To avoid any misunderstanding I am writing now to inform you and the Treasury and Civil Service Committee of two further specific points; and I am releasing this letter to the press.

First, the prospective increase in the paybill between financial years. In particular cash limits or Votes, the actual percentage increase between 1980-81 and 1981-82 in the provision for pay will differ from the announced provision for the increase in earnings from due settlement dates. The number employed may change. In some cases the settlement date is not 1 April, so that each financial year will include a period at the rate before and a period at the rate after the due settlement date. In addition, the increase in the provision for pay between 1980-81 and 1981-82 will be affected in some cases by settlements having been staged in 1980-81, with increases paid later than the usual settlement dates, but such staging not being repeated in 1981-82. This last will contribute some 1 per cent to the increase in the total public service paybill between the two years.

Second, staging. The staging of awards has in the past resulted in a higher rate of pay being carried forward into subsequent years than otherwise would have been consistent with the cash limit. This erodes the effectiveness of the cash limit system and confuses comparisons of the growth of earnings.

/The Government

The Government thinks it desirable for the future to avoid the delaying on staging of awards, and will avoid it where the Government is itself the employer. If, this general policy notwithstanding, a public services employer were to delay or stage an award, the Government, when setting the relevant cash limits for the subsequent year, would not allow for the element of the award which had only been made compatible with the cash limit by such delay or staging.

GEOFFREY HOWE

SECRET until Chancellor's Statement
on 24.11.80 then
Covering CONFIDENTIAL

BRIEFING FOR 24 NOVEMBER ANNOUNCEMENTS

I attach briefing on the Chancellor's Statement to be made on Monday 24 November at 3.30 pm. The brief is classified secret except for those passages marked 'Confidential' or 'Not for use'.

(1) NI - before 1975?
(2) RSG during Pulsi? [illegible]

A. Bottrill

A BOTTRILL

EB

23 NOVEMBER 1980

This is an excellent brief

Mr Ebling : pl cc for
Mr Lupham (at airport)
Mr Griffin
Press Office
Mr Wolfson
Mr Hoskyns
Mr Lankester

+ return to me.

24/11

CONFIDENTIAL
till after Statement 24.11.80

CONTENTS LIST

A1 THE ANNOUNCEMENTS AND GENERAL ECONOMIC STRATEGY

Factual

(i) Announcements fully consistent with Government's medium-term financial strategy of securing sustained reduction in inflation through reduction of monetary growth with complementary fiscal policy.

(ii) No "mini-Budget". Fiscal items cover not this year but 1981-82. Reflect outcomes of usual review exercises ready for announcement at this time of year - broad conclusions of Cabinet discussions of public spending plans and normal autumn review of National Insurance contributions for coming year. New oil tax announced now to allow for consultations with industry and full year's revenue in 1981-82.

(iii) 1981-82 PSBR 1981 Budget time for firm view. As MTFS provides must take account inter alia of impact of recession. There is no PSBR 'target'.

(iv) Monetary target decision to reaffirm present £M3 7-11 per cent (at annual rate) target range to April 1981, follows 1980 Budget commitment to review target this autumn. Aim in 1981 Budget will be to set a new target together with any further measures needed to maintain thrust of MTFS.

(v) Monetary control . Announced conclusions of consultations, based on March Green Paper, about methods of monetary control - form of Bank's controls over money markets and banks. Some significant technical changes to be made which improve control over longer-term, but overriding requirement will remain fiscal policy which complements monetary restraint.

(vi) Public Expenditure. Recession has sharply affected expenditure 1980-81 expenditure expected to be some 1½ per cent higher than at time of Cmnd 7841. Recent decisions minimise departure from earlier plans. Aim for 1981-82 is to keep planned volume of expenditure about 1 per cent below expected 1980-81 outturn. Firm restraint of 1981-82 cash spending essential to keeping cost of programmes under control: thus, for example, 6 per cent factor for pay and 11 per cent for other items in Rate Support Grant cash limit. Total spending and borrowing must be consistent with medium term strategy.

/ A1 continued

THE ANNOUNCEMENTS AND GENERAL ECONOMIC STRATEGY

Positive

(i) Government determined to take sensible and timely action . Increase in employee NIC and oil tax proposal together raise extra revenue of some £2 billion in 1981-82. Essential steps in restraining PSBR for next year so that monetary restraint can be secured without excessive interest rates.

(ii) Inflation: New Industry Act forecast confirms that inflation will continue to fall - essential prerequisite for recovery in output and sustainable economic growth. Annual rate of inflation recorded by 4th quarter of 1981 is expected to be about 11 per cent compared with 15½ per cent forecast to the 4th quarter of this year.

Defensive

(i) Output in course of 1981 expected to remain fairly flat - as in many other countries. Unemployment will inevitably rise further. Reflects worldwide developments, high exchange rate and past failure to restrain pay settlements. Timing of recovery in output and employment depends very much on rate at which UK costs - particularly pay costs - come into line with overseas competitors.

(ii) Restraint of PSBR remains important. Recession can mean that higher level of PSBR than otherwise is tolerable. But remains essential to avoid excessive borrowing that would put unacceptable pressure on interest rates. Hence measures at this stage - oil tax and NIC increase - to help restrain 1981-82 PSBR.

PSBR

(iii) 1980-81 PSBR now forecast at £11½ billion, reflects impact of recession eg on public spending as a result of higher unemployment. On cash-limited programmes and nationalised industry EFLs government has acted to contain pressures as far as possible. Expenditure not out of control.

(iv) Any excess monetary growth in current target period expected to be less than recent statistics might imply: public sector expected to move into surplus in New Year and signs that bank lending may be starting to slow down. Initiatives (eg National Savings) to reduce dependence on gilts and encourage revival of long-term debenture market. Effect on future inflation hard to predict - no mechanistic relationship between money and inflation, wrong to focus on monetary growth over an arbitrary short period when overriding need is to restrain monetary expansion over medium-term.

CONTACT POINT: M FOLGER 233-8737

SECRET until after Statement 24.11.80
then unclassified

A2. CHECK LIST OF MEASURES (Briefs in brackets)

Monetary policy

(i) 7-11 per cent target growth rate retained for period Feb. 1980 to April 1981 (D1)

(ii) Reserve asset ratio for banks to be phased out after consultation on new arrangement for prudential liquidity. (D2)

(iii) Bank of England to change money market operations and last resort lending to allow market greater role in determining short-term interest rates (D2).

(iv) Eligibility to buy index-linked National Savings certificates to be extended in future. (D3)

Public expenditure(details in H1)

Changes to expenditure programmes for 1981-82 due to policy decisions since March 1980 public expenditure White Paper Cmnd 7481):

	1981-82 £m1980 survey prices
Nationalised industries increase in EFLs (other than British Steel)	+ 620
Other policy increases (including special employment measures, industrial support, withdrawal of proposed new health charges and others)	+ 510
EC refunds (agreed 30 May 1980)	- 650
Reduction in programmes (including local authorities current spending, defence, ECGD, social security, DOE and others)	-1070

Revenue

(i) Employees Class 1 national insurance contributions increased from $6\frac{3}{4}$ per cent point to $7\frac{3}{4}$ per cent on 1 April 1981. Payable on earnings of £27-£200 pw. (raised from £23-£165 pw). Estimated to raise around £1 billion in 1981-82. Employers' contribution unchanged. (See G1)

/A2 continued

<u>SECRET</u> until after Statement 24.11.80
then Unclassified

(ii) New petroleum production tax to take effect from 1 January 1981. PRT reliefs to be examined. Expected total yield around £1bn in 1981-82 (See F1).

<u>Pensions</u>

(i) Uprating of retirement pensions and other social security benefits to be adjusted in 1981. Uprating to allow for over provision this year estimated at 1 per cent. (See H7).

CONTACT POINT: C H K WILLIAMS 233-7064

B1. UK ECONOMY - PRESENT SITUATION

(i) Output and demand: Output measure of GDP in Q3 1980 provisionally estimated almost 4½ per cent below average 1979. Decline in demand uneven. General Government consumption has held up, and so have exports until recently. Consumers' expenditure in Q3 estimated to be less than ½ per cent below average 1979. Fixed investment in Q2 was 1 per cent below average 1979, but capital spending by manufacturing, distributive and service industries fell further in Q3. Major reduction in final demand reflects fall in stocks. Industrial output in Q3 9 per cent below average 1979 and manufacturing 11½ per cent down.

(ii) Employment and Unemployment: Employment fell by 400,000 in year to June - just under 2 per cent. Fall heavily concentrated in manufacturing where employment fell by further 150,000 in July and August taken together. UK unemployment (excluding school leavers) was 1.9 million (7.8 per cent) at the October count, a rise of almost 600,000 since December.

(iii) Company finances: In H1 1980 gross trading profits net of stock appreciation and interest payments fell slightly for industrial and commercial companies excluding North Sea activities. Net borrowing rose substantially to £4½bn mainly financed by bank borrowing.

(iv) Earnings and Prices: Over last pay round earnings grew by 21½ per cent, well above the rise in UK prices and increase in earnings of major competitors. Comparatively few settlements so far in current round, but indications of a substantial decline with some settlements in manufacturing in single figures. Prices of materials and fuels purchased by manufacturers has been virtually flat in six months to October reflecting the appreciation of sterling and weak commodity prices. Wholesale output prices rising at an annual rate of 8½ per cent in six months to October. October RPI 15½ per above a year ago.

Balance of payments (See C1)
Exchange rate and Competitiveness (See C2)
Money supply (See D1)
PSBR (See E1)

/B1 continued

Positive

(i) Substantial progress on reducing inflation. Better than forecast and lower wholesale prices still to work through fully.

(ii) Encouraging signs of realism in wage negotiations. Substantial drop from level of last round. Manufacturing settlements in single figures. Industrial stoppages lowest for 30 years.

(iii) Balance of payments strong in contrast to other countries.

Defensive

(i) Last year's rise in consumer expenditure unsustainable as it was not matched by higher output.

(ii) Investment and stocks decline reflect usual cyclical downturn, but also squeeze on profits.

(iii) Recent decline of exports reflects at least partly lost competitiveness and emphasises need for wage moderation.

(iv) Inflation trends better than that inherited. In last six months of previous administration annual rate was 14 per cent and rising. Six monthly rate now lower and trend falling.

(v) Latest 26 per cent year-on-year earnings rise for September distorted by back pay (now) and engineers' dispute (a year ago). Current settlements much lower than in last wage round.

(vi) Unemployment similar in United States, Canada and France. UK however suffering from self-inflicted damage of past wage excesses over productivity and failure to adjust.

Contact point: C Williams 233-7064

B2 Industry Act Forecasts

Factual

1. Industry Act Forecast published on 24 November by Press Notice meets the requirement of 1975 Industry Act for Government to publish two forecasts a year.

2. Coverage of forecast much the same as usual: text includes references to manufacturing and North Sea output and to world trade.

3. Main points of forecast (see Table 1):-

(i) Inflation continuing to fall: perhaps to 11 per cent by end 1981.

(ii) Output fall in 1980 of 3 per cent, in 1981 of 1½ per cent, but with no further fall from current levels.

(iii) Current account of balance of payments forecast to remain in substantial surplus.

(iv) PSBR in 1980-81 now estimated at £11½ billion, 5% of GDP; some fall in percentage of GDP expected in 1981-82.

(v) All forecasts, especially in current circumstances, subject to large margins of error: figures in table 1 of error margins are average errors derived from past forecasts, and not outer limits.

Positive

1. Major reduction in inflation already achieved this year; further substantial fall envisaged next year. Single figure inflation next year a real possibility.

2. Worst of output fall may now be over: forecast shows no further decline either in total output or in manufacturing output in the course of 1981.

3. Average standard of living not likely to decline much, despite much lower rate of pay settlements.

4. Prospect of some fall in PSBR (as percentage of GDP) in 1981-82 consistent with downward trend envisaged by MTFS.

Defensive

1. UK economy facing difficult period of adjustment because of: adaptation to falling inflation; high exchange rate; world recession.

2. Fall in output, especially in manufacturing, greater than expected at this time last year or at Budget time; nevertheless, government forecasts not very far out.

3. Fall in volume of exports in 1981 foreshadowed by: past losses in competitiveness; export orders; tailing off in last few months.

4. PSBR this year higher because of extra government spending, partly because of recession, and because local authorities and public corporations have borrowed more than expected.

5. Can't be more precise about PSBR in 1981-82 because of the difficulties of forecasting the balance between very large (£125 billion or more) revenues and expenditure, and because many fiscal policy decisions on the year naturally await Budget.

6. Unemployment is bound to go on rising for some time, but rate of increase should slow down. /no figures given in Industry Act forecast: the figure of 2.3 million wholly unemployed. GB, appearing in the Government Actuary's Report /to be published on Monday 24 November/ is an assumption - not a forecast - given to the Government Actuary for the purpose of his calculations on the National Insurance Fund./

7. No figure for earnings growth given in Industry Act forecast, but reference to "less than half the rate in previous pay round". Government Actuary's report uses figure - again as assumption, not forecast - of 10½% earnings growth for financial year 1981-82 on 1980-81.

8. Government is merely following all past precedent in not giving forecasts of unemployment, or precise forecasts for earnings.

Contact Point: Mr H P Evans 233 4297

TABLE 1: ECONOMIC PROSPECTS TO END 1981

	Percentage changes 1979 to 1980	Percentage changes 1980 to 1981	Margins of error// for 1981 forecast per cent
A. OUTPUT AND EXPENDITURE AT CONSTANT 1975 PRICES			
Gross domestic product (at factor cost)	- 3	- 1½	1½
Consumers' expenditure	0	- ½	1½
General Government expenditure on consumption and investment	- 1	- 2	1½ /
Other fixed investment	½	- 4	4 *
Exports of goods and services	1	- 3	3½
Change in stockbuilding as a percentage of GDP	- 4	1	1
Imports of goods and services	- 3	0	2½
B. BALANCE OF PAYMENTS ON CURRENT ACCOUNT	1980 £ billion	1981 £ billion	£ billion
	2	2	2
C. RETAIL PRICE INDEX	Percentage changes 4th Quarter 1979 to 4th Quarter 1980	Percentage changes 4th Quarter 1980 to 4th Quarter 1981	Per cent
	15½	11	3

// ~~The errors relate to the average differences (on either side of the~~ central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on government forecasts, notably in November 1978 (see Economic Progress Report Supplement or Economic Trends No. 301, November 1978). The calculations for the constant price variables are now derived from internal Treasury forecasts made during the period June 1965 to October 1978. For the current balance and the retail price index forecasts made between June 1970 and October 1978 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

/ This margin applies to general government consumption only.

* This margin applies to private sector investment only.

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B3 OUTSIDE FORECASTS

(New NIESR forecast is expected in the week beginning 24 November and a new CBI forecast in the first week of December.)

FACTUAL (See also B2 - Industry Act forecast)

(i) GDP forecasts for 1980 and 1981 progressively more pessimistic. Fall of 2½ to 3½ per cent in 1980 is broad consensus (although CEPG in April forecast a fall of 6 per cent). For 1981 there is less agreement. Most forecasts predict falls of ½ to 2 per cent, although ITEM expect 4 per cent drop.

(ii) Inflation forecasts have become progressively more optimistic. Only LBS, however, expect single figure inflation (in consumer prices) by end 1981. Most others forecast 11½-12½ per cent. ITEM, however, predicts increase in the RPI of over 14 per cent in 1981 as a whole.

(iii) Unemployment forecasts are increasingly pessimistic. Almost all forecasters agree on 1.9 million adult unemployment (seasonally adjusted) for 1980 Q4. For 1981 Q4 there is a reasonably narrow range of 2.2 million (LBS) to 2.6 million (CEPG, Charterhouse).

(iv) PSBR Most recent forecasts range from £10 billion (LBS) to £13½ billion (ITEM). For 1981-82, forecasts range between £9½ billion (LBS) to £14 billion (ITEM).

(v) Sterling M3 For 1980-81 growth forecasts mainly fall in the range of 13½ per cent (St James Group) to about 16 per cent (Phillips and Drew). In 1981-82 only LBS expect a growth within the MTFS target of 6-10 per cent. Only Phillips and Drew expect a significant fall in MLR this financial year, although most predict a fall to 11-12 per cent for 1981-82 as a whole.

(vi) Current balance of payments forecasts have become more optimistic, but 1981 forecasts range from a £1½ billion deficit (LBS) to £1¼ billion surplus (Phillips and Drew.)

(vii) Medium-term forecasts There is disagreement on timing of GDP trough and extent of recovery. LBS and Phillips and Drew expect activity to recover from low point in H1 1981.

/B3 continued

For 1982 and beyond LBS forecast a strong recovery with GDP growth of about 2 per cent per annum. Other forecasters are less optimistic. All forecasters expect further reductions in inflation rate. There is general pessimism over unemployment. Camb. Econ. and CEPG forecast over 3 million by 1983 and further increases by 1985. LBS see $2\frac{1}{4}$ million by 1982 but no fall over next four years.

(viii) Policy comments Only LBS has consistently advocated MTFS. Increased PSBR during recession is seen as consistent with stated £M3 targets. Other forecasters range from sceptical (Camb. Econ. and Phillips and Drew) to opposed (NIESR and CEPG.) NIESR favour more direct action on wage bargaining, whilst CEPG champion import controls. Both recommend expansionary fiscal policies.

Positive

(i) All forecasters have become more optimistic on inflation outlook.

(ii) All forecasters now forecast a more favourable current account balance for 1980 and 1981.

(iii) At least some forecasters expect activity to recover in the course of 1981.

Defensive

(i) All forecasts are subject to margins of error. Forecasters have for example, markedly underestimated the fall in inflation and the continuing favourable balance of payments, and there is a wide-range of projections for the PSBR.

(ii) Unemployment forecasts are particularly subject to wide margins of error and uncertainty; and have often been wrong in the past.

(iii) Groups advocating reflation overlook longer-term inflationary consequences of such policies.

(iv) Import controls would risk breaking UK's international agreements, risk retaliation and not guarantee extra output/employment.

CONTACT POINT: A SMITH (EB) 233-4524

C1. BALANCE OF PAYMENTS CURRENT AND CAPITAL ACCOUNTS

Factual

(i) Current account surplus £1.2 billion in first 10 months of 1980, made up of £200 million visible trade surplus and estimated £1 billion invisible surplus.

(ii) Capital account shows inflow of £1.4 billion in first half of 1980. Private non-residents' sterling deposits increased £1¾ billion in first half 1980.

Positive

(i) Current account surplus likely to persist though not on scale of last few months. (see B2 Industry Act Forecast).

(ii) Recent large surplus reflects better than expected performance on invisibles and continuing movement in our favour of terms of trade (excluding oil up 7 per cent in the first three quarters of this year). But main reason is a sharp fall in imports which were £1.3 billion lower in third quarter than in the first largely reflecting destocking.

(iii) Oil account now likely to be in regular surplus.

(iv) Capital outflows following abolition of exchange controls still building up and should offset some upward pressure on exchange rate.

Defensive

(i) It is true that our volume share has probably declined during 1980. This emphasises the need to regain the competitiveness we have lost.

(ii) Good export performance depends on controlling UK costs not exchange rate depreciation.

(iii) No reason to believe that bulk of non-resident sterling holdings are particularly volatile.

CONTACT POINT: MR ALLAN 233-3496

C EXCHANGE RATE AND COMPETITIVENESS

Factual

(i) Sterling has risen around 7½% against dollar and 6½% in effective terms since the Budget. On 21 November it stood at $ 2.3640 (77.4 effective).

(ii) Exchange rate determined primarily by market forces. Intervention by authorities limited to smoothing excessive fluctuations.

(iii) Sterling's underlying strength derives from possession of North Sea oil and market confidence in Government's commitment to defeat inflation.

(iv) Latest estimates of competitiveness:

		Relative normal unit labour costs	Relative export prices	1975 = 100
1978		96.5	108.4	
1979		111.7	115.8	
1980	Q1	126.1	123.3	
	2	134.0	127.2	
	* 3	140	130	*Unpublished Treasury projections. For use only if pressed
	* 4	145	130	

[In terms of relative normal unit labour costs, our competitiveness is about ~~50%~~ 40% worse than in 1978]

Positive

Appreciation of sterling has helped to contain inflation.

Defensive

(i) Current level of sterling not sought as deliberate policy.

(ii) Impossible to control the exchange rate while giving priority to meeting the monetary target.

(iii) Greater part of competitiveness loss stems from UK's relatively high wage increases than from rise in exchange rate. Vital that all take account of competitiveness pressures in negotiating wage settlements.

/continued

(iv) Sustained intervention could not guarantee lower rate but would risk adding to money supply with inflationary consequences.

(v) No reliable relationship between interest rate and exchange rate movements. Interest rates must be determined by domestic considerations.

(vi) Inflow controls unlikely to be effective for more than short period, given sophistication of London's financial markets.

(vii) Some underlying factors may exert downward pressure on rate in future: private sector outflows are growing could accelerate, as could overseas borrowing in sterling market.

(viii) The Industry Act forecast projects little movement in exchange rate from mid-November level. This is a conventional assumption - not a prediction of the actual movement in the rate.

CONTACT POINT: Miss O'Mara 233-4621
Mr Allan 233-3496

D1. MONETARY POLICY: ROLL FORWARD AND INTEREST RATES

Factual

(i) The Chancellor does not propose to roll forward the present monetary target range of 7-11 per cent annual rate for period February 1980 to April 1981. He will announce a new target in the Budget together with whatever further measures are necessary to ensure that the thrust of the medium term financial strategy is maintained.

(ii) Maximum allowable growth over 14 months at top of range was 12.9 per cent. Actual growth from February to October has been about 15½ per cent or about 13 per cent after adjustment for corset distortions. Expressed in annual rates, recorded £M3 has been growing at 23.8 per cent. Underlying rate, after allowances for unwinding of corset distortions, around 20 per cent.

Positive

(i) Accept almost certain overshoot of current target, but recent statistics for £M3 growth seriously distorted by reintermediation after ending of corset controls in June. Full extent of distortions not yet clear.

(ii) Rate of monetary growth expected to slow in rest of target period, particularly in New Year when the public sector moves into surplus. Also substantial sales of National Savings expected and signs that growth in bank lending starting to decline.

(iii) National Savings initiatives (see D3) will reduce reliance on the gilt-edged market and, by making it possible to achieve monetary objectives at lower rates of interest, encourage revival of corporate debenture market.

(iv) In view of above factors, overshoot compared with target will not be large and certainly very much less than figures so far might suggest. Government has decided not to roll forward the monetary target now but to wait until the Budget.

(v) Fiscal measures in Budget will be designed to validate the target for 1981-82, maintaining thrust of medium-term financial strategy.

Defensive

(i) No suspension of monetary target. There will be some overshooting, but £M3 will slow appreciably in rest of target period. We shall not be far above top of range by April, certainly nothing like as far as the growth so far might be thought to imply.

(ii) MTFS not abandoned: The Government remains firmly committed to a progressive reduction in money supply growth. A new target which maintains the thrust of the strategy, will be announced at the time of the Budget. At the same time, whatever fiscal decisions necessary to validate the strategy will be announced. Some decisions, with a long lead time, announced today.

(iii) Not true that an interest rate target has replaced money supply target. Commitment remains to reduction in rate of growth of money supply. Interest rates will need to be adjusted from time-to-time to that end.

(iv) Clawback of excess growth in new target? Obviously, no decisions have been reached on form of target or the range for 1981-82 and later years. Need to reassess carefully at Budget time the underlying excess this year. Will decide target then in the light of this reassessment, the growth of other aggregates and developments in the economy generally.

(v) Will recent excess growth produce inflationary burst in 12-18 months? No. Important not to draw conclusions based on short period. The latest Greenwell's bulletin, not always supportive of Government policy, points out the error of this approach. We expect second half-year monetary growth to be much lower. Inflation is coming down sharply and the forecast for the next 12 months is 11 per cent.

D1.

SECRET AND PERSONAL

until after Statement 24.11.80
then Unclassified

Essential that monetary growth should decelerate sharply to avoid re-acceleration of inflation as economy returns to fuller capacity use.

Contact point: H DAVIES 233-4533

D2 MONETARY CONTROL TECHNIQUES: MBC

FACTUAL

1. As foreshadowed in Green Paper, Reserve Assets Ratio will be abolished as soon as consultations with banking system regarding alternative prudential arrangements can be completed.

2. No decision for or against Monetary Base Control now, but:

   (i) Bank and Treasury considering future of $1\frac{1}{2}$ per cent cash ratio.

   (ii) Statistics to be collected for "retail" money (akin to old M2 series).

3. Changes will be introduced in the Bank of England's methods of intervention in money markets:-

   (i) Less emphasis on discount window (lender of last resort) lending, and more on open market operations.

   (ii) Aim of open market operations will be to keep very short term interest rates within band determined by the authorities. Band will not be announced.

   (iii) At appropriate stage, Bank might cease to announce MLR, and would normally charge a rate above market rates on its discount window lending.

4. Bank has issued a briefing note for the press on these changes.

Line to Take

1. Government is attracted by the idea of moving towards MBC, but no firm decision can be made on basis of present knowledge. Evolution of monetary control system must be gradual, learning from experience.

2. Monetary base control would not provide short-term control of £M3 or other wide monetary aggregates. Entails setting targets either for a relatively narrow aggregate (eg. "retail" deposits) or for base itself. Market would determine short-term interest rates consistent with that target. Already take some account of narrow aggregates in setting interest rates under present system.

3. To judge the potential of MBC, more information needed:-

(a) For non-mandatory MBC, need to know extent of banks' demand for balances with the Bank of England, and its relation to money supply and price level. Cannot learn this whilst 1½ per cent requirement in force.

(b) For mandatory MBC, need to know characteristics of "retail" deposits, since a reserve requirement related to wholesale deposits would produce distortions similar to those observed under SSD scheme.

4. Other steps announced today are desirable in own right and appropriate to evolution towards MBC:

(a) More flexible approach to money market operations will give market more of a role in determining structure of short-term interest rates. Banks will no longer be certain that they have access to unlimited supply of cash at known price; will, therefore, have more incentive to keep their lending rates in line with market.

(b) Abolition of Reserve Assets Ratio will remove a factor distorting relative yields between Treasury bills and other short-term financial instruments. The Bank will be examining potential for developing wider market in short-term central government debt. This might help monetary control by providing greater flexibility to funding programme.

5. The Bank will discuss operational details of changes with institutions affected as soon as practicable. New arrangements should be in place in Spring.

DEFENSIVE

1. Nothing Here to Improve Control of £M3

Control of £M3 a medium-term objective to be achieved by the general thrust of government policies including fiscal policy and debt sales. Commitment to MTFS stands.

2. Will Government be Abandoning £M3 in Favour of Narrower Aggregate?

No, under any system we shall need to control wider aggregates in the medium term.

3. How Will More Flexible Interest Rates Help Monetary Control?

May change way banks charge for advances and accelerate changes in overdraft system - bank lending will then become more responsive to market interest rates. Will reduce drama associated with MLR changes. May pave way for a later decision to set objectives for monetary base instead of interest rates.

4. <u>How do the New Arrangements Allow a Greater Role for the Market in Determining Short Term Interest Rates?</u>
The Bank will only act to limit movements in very short term interest rates (overnight, 7 day rates). Band within which it will seek to keep these rates will not be announced. Authorities' views will therefore be less overt, leaving market more of a role in determining the structure of other interest rates.

5. <u>Will the Band Be Set With Reference to Movements In the Monetary Base?</u>
Authorities will take account of same factors as now determine choice of MLR. When more information is available about the behaviour of the base, it might become appropriate to take this into account too.

6. <u>How Much Volatility in Short-Term Interest Rates will the Bank Tolerate?</u>
No precise answer possible. But intend to proceed gradually. Wild gyrations in short-term rates can be ruled out.

7. <u>Will MLR Disappear?</u>
At some stage the Bank may cease to announce a MLR. Not possible to be more precise; changes to the status of MLR could have legal implications which must be examined further.

8. <u>Is This a Return to the Formula System for MLR?</u>
No. The relationship between MLR (or its successor) and comparable market rates will be at discretion of authorities. No set formula.

9. <u>Money Market Assistance: Does It Go On?</u>
Measures necessary to prevent RAR from undesirably affecting interest rate levels and perhaps artificially inflating money supply ("round tripping"). Green Paper explained why it is neither necessary or suitable for controlling money supply. Solution depends on replacing RAR by alternative prudential arrangements. In meantime, Bank is considering transitional measures to relieve reserve asset pressure which would reduce need to give substantial amounts of money market assistance (eg. by modifying definition of reserve assets).

10. <u>Will the Discount Houses Disappear?</u>
New methods of operating in money markets assume a continuation of the discount market in its present form. Discount window facilities will continue to be confined to members of London Discount Market Association.

11. Why not abolish RAR now if counter productive for monetary control purposes?

Reserve asset ratio has a prudential function in determining bank's holdings of liquidity. Premature to abolish it until alternative arrangements have been made. Further consultations with banks required.

Contact Point: Mrs Lomax 233 5570

D3 NATIONAL SAVINGS

Chancellor announced eligibility to purchase Index-Linked National Savings certificates will be widened in future to maintain momentum of National Savings and attract at least £3 billion next year. (At present those aged 60 and over may buy up to £3,000 of Second Index-Linked Issue, which went on sale at Post Offices and Trustee Savings Banks on 17 November.)

Positive Points

(i) Government planning to secure about £1.5 billion of additional funding from new issue during current financial year as major component of overall contribution from National Savings of about £2 billion.

(ii) Extensive campaign of TV and press advertising.

(iii)Making current issue available to men aged 60 and over ends previous discrimination in favour of women.

(iv) Substantial contribution from the personal sector will reduce need for gilt sales and should help revive long-term debenture market.

Defensive Points

(i) Effect on building societies: Some of inflows to National Savings will be at expense of building societies, but their loss expected to be less than half gain to National Savings. Inflows to societies have recovered strongly in recent months, while demand for housing finance appears to have slackened.

(ii) Inflows in excess of £3 billion into National Savings will indeed establish new records for this source of funding but are consistent with what has been achieved before in terms of a proportion of personal sector's savings.

Contact Point: Mr G Ward 233 5466

D. THE STATEMENT AND THE MTFS

Factual

(i) The MTFS set out the government's commitment to reduce the rate of inflation and thereby secure the conditions for sustainable growth.

(ii) The principal means to ensure the fall in the rate of inflation was a commitment to declining monetary growth (to a target range of 4-8 per cent during 1983-84). There were no precise targets for the intervening years 1981-82 and 1982-83.

(iii) Control of the money supply is not to be achieved by persistently high nominal interest rates, but by control of public sector borrowing.

(iv) There are no targets for the PSBR. The projections of the PSBR in the MTFS were purely illustrative.

> "Fiscal policy will be operated so that the PSBR for any particular year will be consistent with declining monetary growth in the particular circumstances of the time." (MTFS, paragraph 12)

Positive

(i) The extra revenues, the cuts in public expenditure volumes (to offset increases in other categories), and the firm control on public sector pay will contribute towards control of the PSBR in 1981-82.

Defensive

(i) Does the failure to control the money supply and the PSBR in 1980-81 mean that the financial strategy has failed? No. The government is just as firmly committed to declining monetary growth in future years as at the time of the MTFS.

/continued

(ii) Will the likely failure to achieve the 1980-81 target result in changes to targets for later years? The government intends monetary deceleration to be broadly along the lines set out in the MTFS. The only target is for monetary growth of 4-8 per cent in 1983-84. The target rates of growth in the intervening years will be set at the time.

(iii) PSBR in 1981-82 to be too high to achieve monetary growth consistent with MTFS? The government will take whatever measures are necessary to achieve a satisfactory PSBR in the particular circumstances at the time of the 1981 budget. The measures set out in the Chancellor's statement are not the 1981 budget.

(iv) Is allowing the PSBR to rise in a recession contrary to the MTFS? No. In a recession a higher PSBR than usual should be consistent with a particular growth of the money supply (at acceptable interest rates). The judgement on what PSBR is right for 1981-82 will be taken at the time of the budget.

Contact point: G R LEWIS 233-3093

E1. PUBLIC SECTOR BORROWING REQUIREMENT

Factual

(i) PSBR out-turn in first half of financial year 1980-81 was £8 billion seasonally adjusted. High out-turn reflects partly uneven timing of receipts and expenditures, over-spending on defence and lower than expected tax revenues. Borrowing should be lower in rest of financial year - reflecting rising North Sea tax revenues , receipts from asset sales and refund from EC Budget.

(ii) PSBR for 1980-81 as a whole now expected to be around £11½ billion (5 per cent of GDP at market prices) compared with £8½ billion FSBR forecast. Increase reflects at least partly unanticipated effects of recession on public spending and on trade of nationalised industries. (See B2 Industry Act forecast)

(iii) PSBR prospect for 1981-82 is for some fall as a percentage of GDP on the basis of the fiscal and monetary policy assumptions used in the Industry Act forecast i.e. taking account of the fiscal decisions announced by the Chancellor.

Positive

(i) Government remains committed to MTFS, PSBR consistent with declining monetary growth.

to aim in
(ii) Final decision about PSBR /for/ 1981-82 must await the Budget, but tax and spending measures announced today demonstrate Government's determination to check public borrowing.

(iii) PSBR for 1981-82 will be consistent with Government's monetary objectives.

(iv) Interest rates (See D1).

Defensive

(i) Government is not abandoning MTFS. It was always made clear that fiscal policy would be operated so that PSBR for any particular year was compatible with the Government's monetary objectives (FSBR - page 18). There is no PSBR target.

(ii) Realistic to allow for some increase in public spending and borrowing as a result of recession. But totals must be consistent with financial strategy and continued reduction in inflation if sustainable growth is to be renewed.

(iii) PSBR forecasts subject to wide error margins - emphasised at time of Budget forecast (± £3 billion). Uncertainties for 1981-82 must similarly be stressed.

CONTACT POINT: A R H BOTTRILL 233-5886

F1 CHANGES TO NORTH SEA FISCAL REGIME

Factual

(i) New tax on UK oil revenues will take effect from 1 January 1981. Additional to existing petroleum revenue tax (PRT). (Timing of payments still to be decided).

(ii) It will be charged, on a field basis, on gross revenues less a deductible allowance - as in (v) below. (PRT, by contrast, is charged on revenue less deductions for actual expenditure and a deductible oil allowance.)

(iii)It will be deductible for PRT and Corporation Tax purposes.

(iv) It is intended to increase net yield from oil taxation by about £1 bn in 1981-82 and by significant amounts (though less than £1 billion) in later years. (For expected North Sea revenues see F2)

(v) For illustrative purposes, increased yield would be achieved by setting rate at 20% and deductible allowance at value of 1 million tonnes of oil for each field for each year.

(vi) Detailed proposals will be introduced in 1981 Finance Bill after discussions with the industry.

(vii)Ministers will also examine present scheme of PRT reliefs (uplift, safeguard, oil allowance) in light of changed conditions (oil price increases, cost increases, technical experience, production and tax changes) since reliefs introduced. Again, changes will take effect from 1.1.81 and be introduced in 1981 Finance Bill after discussions with the industry.

(viii)No decision taken yet about abolition or retention of the PRT advance payment system.

(ix) Outline of proposals set out in Inland Revenue Press Release.

Positive

(i) Need to strike fair balance between nation and companies in sharing fruits of North Sea.

(ii) Oil companies have benefited from very substantial increase in oil prices in last two years (and despite two tax changes). Since fourth quarter 1978, world price of oil (in $) has risen 150 per cent. Rise in £ exchange rate means rise in £ price is less - 110 per cent. This is still considerably greater than rise in general prices level.

(iii)The new tax is justified on its own merits in the light of the profitability of the North Sea. The increase in yield will obviously help with the PSBR (and therefore interest rates).

(iv) Announcement in advance allows time for companies to have meaningful discussions with IR on details.

/continued

Defensive

(i) Why a new tax? PRT currently narrowly-based; so being presently paid by relatively few companies in relatively few fields. Could not yield same extra revenues without undue pressure on those companies and those fields. New tax will spread effect more fairly than charges in PRT raising equal amount of revenue.

(ii) Penalising profitable companies? Charges should not deprive companies of a fair return on North Sea projects and exploration.

(iii) Effect on company profitability? Will depend on type of fields owned by Company. In general likely rates of return only slightly reduced. Proposed deductible allowance will help to shelter smaller fields.

(iv) Effect on exploration and development? North Sea activity currently buoyant - shortage of some equipment. Very conscious of need to preserve attractiveness of North Sea as an area for new investment.

(v) Effect on 7th Round Licensing? No reason to believe proposals will discourage companies from taking up and exploiting any acreage they are offered. The proposals have been developed in full consultation with Departement of Energy.

(vi) Impact on marginal fields? Proposed allowance intended particularly to help shield marginal fields.

(vii)Stability assurances? Fully appreciate importance of stability for industries with long lead-times for investment. But never ruled out change in any circumstances. Oil world and UK economy have changed greatly since PRT introduced; changes have become too great for PRT to cope with.

(viii) Changes to PRT reliefs. As PRT rate has increased from its original level, some of PRT reliefs may have had unforeseen effect. Full proposals in 1981 Finance Bill. But IR will discuss possible changes with industry.

(ix) World oil prices now stable? True they have been more or less stable since mid-1980. But have risen over last two years. Government now had further time to consider implications of the second oil price explosion for the N. Sea fiscal regime.

Contact point: Mr Haigh IRD 438 6670

F2 FORECASTS OF GOVERNMENT REVENUES FROM OIL AND GAS PRODUCTION IN THE NORTH SEA

Factual

(i) Industry Act forecast includes forecasts for total North Sea revenues. These are:-

£billion at 1980-81 prices [1]	
1980-81	4
1981-82	4½ - 5

Figure for 1981-82 includes the additional revenue to be raised by means of supplementary tax announced in the Chancellor's Statement. (See F1).

(ii) Figures cover royalties, PRT, corporation tax, and (for 1981-82) extra revenue from the supplementary tax. They include receipts from all companies operating in North Sea including payments by BGC and BNOC. They exclude operating surpluses of BGC and BNOC.

(iii) In spite of the additional revenue in 1981-82 from the announced tax changes c. £1billion at current prices - the total government take at constant 1980-81 prices will be only £0-½billion higher than forecast at the time of the Budget.

(iv) Downward revision to the forecast of government take (if the effects of the supplementary tax are ignored) is partly the result of lower production and upward revision to forecasts of investment. (The oil production estimate for 1980 of 81 million tonnes given in the new Industry Act forecast is below the centre of the 1980 Brown Book range.) [IF PRESSED: the same may be true next year.]

(v) After 1980 Budget, Government published forecasts of its North Sea revenues for each financial year until 1983-84 (ie. the period of the MTFS). There are no revised forecasts for 1982-83 and 1983-84. [IF PRESSED: Revised forecasts for later years will probably be available at or after the 1981 Budget.]

Defensive

(i) Forecasts of government revenues from the North Sea take account of developments so far this year in world oil prices and exchange rate./Because

1 North Sea revenues with effects of general inflation removed by deflating with GDP market price deflator

Because prospects for these are inherently uncertain, forecast of government revenues in 1981-82 is subject to a wide margin of error.

(ii) How does latest forecast for the real price of oil relate to that used at the time of the Budget?

Budget forecasts of North Sea revenues were based on assumption of a world oil price constant in real terms at roughly the level obtaining at end of first quarter 1980. So far this year, real world oil price has turned out to be a little higher than this; but this has been offset by £ exchange rate being a little higher. Current assumption for 1981 is that real world oil price is likely to remain fairly flat, perhaps rising by 1 per cent year on year.

(iii) Are Government's forecasts for NS revenues too low (as suggested by TCSC)?

No. It is true that some outside forecasters were suggesting much higher North Sea revenues at time of Budget, but these other forecasts have since tended to be revised down, bringing them much closer to the government's projections. (At Budget time outside forecasters had no knowledge of the lower production ranges later published in 1980 Brown Book).

Contact Point: P Sedgwick 233 8931

F3 STOCK RELIEF

Factual

(i) The new scheme announced on 14 November will:-[1]

(a) virtually remove the threat of clawback for continuing businesses;

(b) limit relief to the effects of price changes on a business's opening stocks;

(c) base the relief on the change in a new "all stocks" index;

(d) restrict relief in the largest cases (i.e. where stocks exceed £1 million) to the extent that stocks are financed by trade credit or other borrowings; and

(e) abolish the "profit restriction".

(ii) Cost and distribution: The new scheme will, in present circumstances, give significantly more relief to industry and direct it to those businesses which need it most.

(ii) Full details of proposals in Consultative Document and Inland Revenue Press Notice (both on 14 November).

Positive

(i) Removal of Clawback: A major benefit to industry at a time when many businesses having to reduce stocks to ease liquidity problems. Under new scheme, the threat of clawback will virtually disappear for continuing businesses.

(ii) Extra relief: Scheme will give significant extra relief. Difficult to be precise: figure depends on level of stocks, profits and rate of inflation. [If pressed: the figure of £300 million revenue foregone quoted in the press may not be far wrong.]

(iii) Benefit to manufacturing: Increases in manufacturing industry's share of relief will increase [from about 45% of total to around one-half. – IF PRESSED].

(iv) Small businesses: Will benefit from ending of profit restriction; many more will get relief.

1 Clawback is the recovery of past relief, when the book value of stock falls.

/continued

(v) Tackling misuse of present scheme: New scheme will deal with 2 points which have attracted widespread criticism:-

(a) full relief will no longer be given in respect of increases in volume of stocks (which has encouraged the boosting of stocks at year end);

(b) relief will be abated where large businesses have financed stocks on credit, so that the inflationary costs are borne not by the business but by its suppliers.

Defensive

(i) Credit restriction: This is necessary to withdraw relief from those who do not bear the inflationary costs of holding stocks. And small businesses need not worry about it (because of £1 million threshold).

(ii) Use of single index: The reasons why the Government have opted for this (arguments of principle and practicality) are set out in the Consultative Document.

(iii) Not SSAP 16: Both Statement of current Accounting Practice No.16 on current cost accounting and the new scheme share same broad objective, i.e. to take account of the effect of price changes on profits. The Consultative Document explains why stocks adjustment in SSAP 16 could not be used for tax at present. This does not rule out development of both systems in light of experience.

(iv) The £2,000 de minimis limit: Profit restriction in the present scheme saves a lot of work on small claims where tax is relatively insignificant. The £2,000 will do same.

(v) Stockbrokers Phillips and Drew claim no extra benefit will accrue to business overall and that manufacturers will lose out and retailers gain. They also raise question of current cost accounting.

(vi) Problems over Vesting Clauses

Suggestion that companies might face large back tax bills is being looked at urgently; Ministers will ensure no question of past relief being withdrawn and that stocks concerned will continue to qualify for relief.

CONTACT POINT: Mr McGivern IRD 438-6412

G1: NATIONAL INSURANCE CONTRIBUTIONS

1. Factual

Chancellor announced following changes for 1981-82. (Further details in Bill and Government Actuary's Report published to morrow Tuesday 25 November.)

(i) Employees' Class 1 contributions increased by one percentage point from 6.75 per cent to 7.75 per cent, made up as follows:

(a) 0.25 per cent to maintain the Fund in balance;

(b) 0.25 per cent to increase the NHS allocation from 0.4 per cent to 0.65 per cent;

(c) 0.5 per cent to make up the income lost to the Fund (about £500 million) caused by the reduction in the Treasury Supplement (from 18 per cent of contributions to the NI Fund to 14.5 per cent).

(ii) Contribution paid by employees earning between £27 a week (old rate £23 pw) and £200 a week (old rate £165 pw). Above upper earnings limit, cash contribution remains constant.

2. Employee (not contracted out) individual liability is shown below:-

Weekly earnings £	1980/81 Contribution £	Changes on account of increased earnings limits £	Increases on account of increased contribution rates £	total increases	1981/82 total contribution £
23	1.55	-1.55		-1.55	NIL
27	1.84	-	+0.25	+0.25	2.09
60	4.07	-	+0.60	+0.60	4.67
100	6.77	-	+1.00	+1.00	7.77
130*	8.79	-	+1.30	+1.30	10.09
165	11.14	+0.01	+1.66	+1.67	12.81
200	11.14	+2.36	+2.00	+4.36	15.50

*Approximate current average weekly earnings of full-time male employees.

3. No increase in employers' rate (currently 10.2 per cent) and no change in the NI surcharge (currently 3.5 per cent).

4. Rates for self-employed and voluntary contributors will be adjusted but excluding element 1(i)a above. Other rates to be adjusted as appropriate.

5. Estimated yield will be about £1 billion in 1981-82.

Positive

Reasons for the change

(i) Reduction in Treasury Supplement reduces PSBR in 1981-82. Contributions have to be raised to keep NI Fund in balance;

(ii) Expenditure from Fund will increase in 1981-82 because of the increase in unemployment and higher upratings. Income from contributions no more than expected increased expenditure on benefits.

(iii) Treasury Supplement has stood at 18 per cent of contributions since 1975. Substantial increase in non-contributory (ie. wholly Exchequer-financed) benefits over the years. Government considers appropriate time to readjust balance of financing social security budget between insured persons, employers and general taxpayer.

(iv) Burden of adjustment will fall on insured persons not employers. Employers have taken more than fair share of burden of economic adjustment so far. Ratio of employers' contributions to employees' contributions (excluding NIS) has increased from 1.1:1 to 1.6:1 between 1966 and 1979.

(v) Allocation to NHS has declined as proportion of total health expenditure over years. If Government is to preserve its commitment to maintain spending on health service, contributor must pay more.

Defensive

(i) This is an increase in the tax burden. No. This has nothing to do with tax. Merely asking insured people to finance more of expenditure on benefits and health service from contributions, rather than expecting the general taxpayer to finance them.

(ii) Will you then reduce taxes to compensate? Wait for the Budget. The Chancellor will then consider the tax burden in the wider context in the light of the options open to him. Decisions on contributions are needed now.

(iii) Isn't this regressive? This is the normal way of financing National Insurance. It is progressive between the earnings limits of £27 pw and £200 pw. If pressed. True that NIC bites at lower level of income than income tax; but real increases in income tax are also laid upon the lower paid; especially if they take the form of lowering real tax thresholds.

(iv) The NI Fund has substantial balances, why not use them? That would incur a current deficit on this fund and increase the PSBR. Balance in fund has declined in real value over the years.

(v) Why not raise more from e.g. taxes on drink and tobacco? This is not a Budget. Tax options will be considered in the usual way nearer to the Budget.

(vi) Is NI Surcharge affected by these changes? NIS is unchanged. It will continue to be levied, as a surcharge on employers' NICs, at the rate of 3½ per cent on gross weekly earnings up to the upper earnings limit (£200 after April 1981).

(vii) But you are increasing contributions while reducing benefits? Decisions on uprating benefits have little impact on overall finances of NI Fund in 1981-82. Any adjustment in contributions to reflect any lower expenditure on benefits will be considered at next contributions review (November 1981).

(viii) Increase in employees' contributions inconsistent with attempts to hold down wage increases. Main objective is to reduce PSBR; if PSBR inconsistent with our medium-term financial strategy result would be worse inflation.

(ix) Adjustment in Treasury Supplement undermines the basis of the new pension scheme. No effect on new pension scheme. Earnings limits and contribution rebate are not affected by adjustments in Treasury Supplement.

(x) Why not abolish upper earnings limit? Not possible to abolish UEL without significant restructuring since it sets a limit for entitlement to earnings-related pensions and for main pension guaranteed by contracted out schemes.

(xi) How much of increased contribution can be attributed to higher unemployment? Wait for the Government Actuary's report. As the Industry Act forecast indicates, thelevel of unemployment is expected to be higher in 1981. Government Actuary has been asked to assume that average level of GB unemployment in 1981-82 will be 2.3 million excluding school leavers.

Contact Point: D Butler (SS1) - 233 - 3932

H1 PUBLIC EXPENDITURE: 1981-82
(All figures are in 1980 Survey Prices)

Factual

(i) The Government has now completed its review of the expenditure plans for 1981-82 as part of the normal public expenditure planning cycle.

(ii) The main underlying problem which it has had to face has been the effect of a recession which is rather steeper and heavier in its impacts on both sides of the public accounts than foreseen earlier.

(iii)Allowance has to be made for substantial increases in certain open-ended programmes, eg. social security expenditure.

(iv) The external financing limits for nationalised industries (excluding British Steel) have been increased by £620 million, reflecting the deterioration in trading conditions. The industries are being required to secure substantial economies of more than £750 million.

(v) There is an increase of £245 million in provision for special employment measures and some £50 million in provision for selective assistance for investment and support for industrial research and development.

(vi) Substantial reductions of nearly £1.1 billion have been made to other programmes. Main reductions include:

	£m
Local Authority current expenditure (3% rather than 2%)	165 (England)
Defence	200
Social Security - not carrying forward excess uprating and other measures	66

(vii)RSG 1981-82 to be calculated on basis of lower percentage than present 61% England and Wales (68% Scotland). Government will consult local authorities. [IF PRESSED: "lower percentage" means maximum of 60 per cent (England and Wales).]

(viii)There will be European community refund in 1981-82 of some £650 million.

Positive

(i) Government maintains its commitments to reduce the volume of public expenditure in the medium-term. Volume of planned expenditure is being redistributed, with substantial reductions in some programmes partly offsetting increases due to the recession.

(ii) Cash limits are being set to slow down very sharply the rate of growth of costs, especially on public service pay.

(iii) Shift away from the plans of the previous administration made last year is being sustained although some adjustment to the earlier plans to take account of the changed economic circumstances is now thought appropriate. Planned total for next year will still be some £5 billion below level planned by previous government.

(iv) Aim is to keep planning total for volume of public expenditure in 1981-82 about 1% below outturn now expected for the current year.

Defensive

(i) Final planning total has not yet been set - that will be included in next public expenditure White Paper. Precise figure will depend both on economic assumptions then thought appropriate and on decisions still to be taken (notably British Steel Corporation EFL and child benefit).

/BACKGROUND INFORMATION: figures quoted by Chancellor for outturn for this year and aims for next year point to planning total in the range of £78 billion - £78.5 billion. The press can be helped with this arithmetic, but no official imprimatur should be given to a specific figure at this stage - that is for the White Paper to do./
For comparison of 1980 survey prices with Cmnd 7841, see Press Notice.

(ii) White Paper will be published with Budget, when it can be set against tax plans, and when remaining decisions both for next year and following years have been taken.

(iii) Present statement is about the expenditure decisions which have to be taken at this stage if the various spending authorities - nationalised industries, local authorities, health authorities, Government departments etc - are to have time to put the plans into effect.

(iv) The services breakdown of reduced volume plans for LA current spending will be given in the RSG consultative document later this year.

(iv) Rate increases need not be excessive - despite lower RSG support - if councils plan in line with cost targets on volume, and stick to tough pay bargaining posture. Manpower may be key to success.

Contact Point: Miss M Peirson 233 7208

/H1 ANNEX

SUMMARY OF PUBLIC EXPENDITURE POLICY DECISIONS

A. Volume

1. The changes in expenditure programmes for 1981-82 due to policy decisions since the March Public Expenditure White Paper (Cmnd 7841) are:

	1981-82 £m at 1980 Survey Prices (b)	
Nationalised Industries		
Increases in EFLs (other than for British Steel) including revised provision for shortfall		+620
Other policy increases (a)		
Special employment measures	+245	
Industrial support	+ 52	
Industry (other)	+ 10	
Health (withdrawal of some proposals for new charges)	+121	
Civil superannuation (accelerated retirement of civil servants)	+ 64	
Trade	+ 21	+510
Other significant policy changes: (a)		
(i) Local Authority Current Expenditure (England) - reduction by about 3% instead of 2% from planned level for 1980-81	-165	
(ii) Further changes in Departmental programmes (excluding elements of local authority current expenditure included in (i))		
Agriculture Departments	- 36	
Department of Employment	- 25	
Department of Transport	- 21	
Department of Environment (including PSA)	-158	
Home Office	- 17	
Department of Education and Science	- 52	
Office of Arts & Libraries	- 10	
Department of Health & Social Security (health)	- 25	
(iii) Other Departments		
Defence	-200	
Foreign & Commonwealth Office	- 16	
Export Credits Guarantee Department	-166	
Department of Health & Social Security (social security)	- 66	
Scotland, Wales and N. Ireland (including changes to local authority current expenditure in Scotland and Wales)(c) (about)	- 90	
Other (about)	- 15	-1,060
EC refund agreed on 30 May 1980		- 650

/ Footnotes - see next page

2. The changes take account of the salary savings expected in 1981-82 from the progressive reductions in Civil Service numbers to 630,000 by 1984.

3. The list does not include changes where the exact amount will be decided later eg British Steel and Child Benefit. Nor does it include the estimating adjustments, eg for demographic and economic factors, which will be made in the public expenditure White Paper to be published at the time of the Budget. The White Paper will include further details of the policy changes for 1981-82 and will set out the plans for 1982-83 and 1983-84.

4. The figures are in the prices used for the 1980 Public Expenditure Survey. "1980 Survey Prices" means for most expenditure broadly the prices of late 1979, which were some 18 per cent higher than the 1979 survey prices used in Cmnd 7841. For transfer payments (including overseas aid), 1980 survey prices are generally estimated average prices for 1979-80, ie about the same as those in Cmnd 7841, as a result of a change of definition since that White Paper.

B. Cash limits

5. Cash limits and Votes for expenditure other than pay will allow for an average level of prices in 1981-82 11% higher than the corresponding level in 1980-81.

6. The cash limits for the Rate Support Grant and for the Universities' Grant will include allowance for increases in earnings of 6% in annual settlements due before 1 August 1981, and also provisionally of the same amount for annual settlements due after that date. The allowance for pay in other cash limits, and Votes, will be so set that the pay of the relevant groups is dealt with broadly within the same financial disciplines. The outcome of settlements in particular cases will depend on the way in which the cash is allocated.

Contact Point: Miss M Peirson 233 7208

(a) The increases and reductions shown include the net effect of various minor policy changes.

(b) Total changes are rounded to the nearest £5 million.

(c) The exact changes to Scotland, Wales and Northern Ireland programmes, in parallel with those to English programmes, will be given in due course

H2 1981-82 CASH LIMITS

Factual

(i) The rate support grant cash limit will provide for 6 per cent annual increase in earnings from due settlement dates. On expenditure other than pay it will provide for increases in prices of 11 per cent between the average level of 1980-81 and 1981-82.

(ii) Exepnditure in other parts of the public service will be handled within broadly the same financial disciplines.

(iii) As made clear in Chancellor's letter of November 24 to Mr du Cann, (reproduced in Treasury Press Notice) Government will discourage staging or delaying implementation of pay awards. Cash limits will be set to ensure that no financial advantage can be gained in this way.

Positive

(i) It is the Government's policy that pay should be negotiated in the framework set by cash limits. Cash limits reflect what can be afforded.

(ii) 6 per cent is not a pay norm. It is for managers to decide how to allocate the money available. Earnings increases can be higher or lower. If they are higher it will be necessary to make offsetting savings e.g. through further manpower economies ~~or~~ on other expenditure. If they are lower it will be easier to achieve departmental programmes.

(iii) Staging can be a way of avoiding the discipline of cash limits. It enables wage bill to be accommodated in one year's cash limit at expense of carrying additional costs forward to following year.

(iv) If an award is staged in future, the cash limit will be set so that the element of the cost deferred into the following year by staging willmean that correspondingly less cash is available for the new pay award in that year.

/H2 continued

Defensive

(i) No decisions have been announced to apply the 6 per cent provision to pay other than to local authority employees.

(ii) 6 per cent relates to earnings. Implication for settlements depends on the circumstances for individual groups.

(iii) Figure of 6 per cent applies to settlements falling in 1981-82 and in the remainder of 1980-81. For settlements after 1 August 1981 (i.e. next pay round) is provisional. Government will decide what can be afforded for public service settlements in next pay round nearer the time.

(iv) 11 per cent is consistent with the RPI figure in the Industry Act forecast. It relates to particular transactions of the public services, not to retail prices generally. Based on increase between financial years, not between fourth quarters.

(v) Squeeze on volume of expenditure in 1980-81 is always possible. It depends on actual price increases on the particular goods concerned. It is not anticipated that these factors will produce any significant squeeze.

(vi) Certain awards were staged in the 1979-80 pay round. Provision will be made in 1981-82 cash limits for the staged element in these awards. They were entered into in good faith and it would not be appropriate to apply a retrospective penalty by refusing to provide for extra cost in 1981-82.

(vii) Providing for awards staged in 1979-80 pay round will add some £275 million, or about 1 per cent to public service pay bill in 1981-82. Groups concerned are teachers (over £200 million), non-industrial civil servants (about £60 million) and university staff (about £15 million).

(viii) Increase in public services paybill between 1980-81 and 1981-82 depends on planned numbers, settlement dates and financing of staging. Financing past staging adds about 1 per cent to the paybill. For public services as a whole the increase is likely to be around 7 per cent but this will vary for individual groups.

/H2 continued

(ix) Public service employees real pay being reduced? Workers throughout the economy likely to find have to take reductions in real earnings. Public services have had substantial rises recently. They enjoy greater job security.

(x) How will public services pay/rises compare with others? This is what public service employers can afford. Private sector workers must settle for what their employers can afford.

CONTACT POINT: S A ROBSON 233-8633

H3 PUBLIC EXPENDITURE 1980-81 (All figures current prices)

i. Factual

(i) The volume of public expenditure in 1980-81 is now expected to be some 1½% above the levels in the last public expenditure White Paper (Cmnd 7841).

(ii) The FSBR put the estimated outturn on Cmnd 7841 planning total after shortfall at £91.6 million. (Table 16 of Red Book)

(iii) On top of the increased volume of expenditure there have also been additions to public spending arising from pay and price increases; the most notable example is the £203 million increase announced in the defence cash limit.

(iv) There have been 40 changes to cash limits so far this year giving rise to a net increase of £220 million on a cash limits total of some £46½ billion.

(v) The main increase to cash limits have been defence (+£203 million), fisheries aid (+£13 million) and Northern Ireland (+£16 million). The main reduction Energy R & D (-£16 million) and labour market services (-£10 million).

Positive

(i) Cash limits are being respected. Expenditure is being closely and effectively monitored. There have been difficulties on defence, on local authority current expenditure and on local authority capital expenditure on housing. In each case the problems were quickly identified and action taken.

(ii) In certain areas expenditure programmes are necessarily open-ended and cannot be subject to cash limits or controlled within the year eg social security expenditure depends on unemployment. The depth of the recession is increasing expenditure in these areas.

(iii) Winter Supplementary Estimates (to be presented to the House on December 2) have been taken fully into account in the Chancellor's statement and in the Industry Act PSBR forecast for 1980-81.

Defensive

(i) Major extra cash needs for volume increases in the planning total include special employment measures (+£200 million), agricultural support (+£100 million), social security (+£350 million) and reduced shortfall (+£800 million). To be set against this there is the EC refund of £650 million.

(ii) These increases reflect the increased numbers of qualified recipients (employment measures, social security) and harvests (agriculture). Part of the reduction in shortfall reflects the speed at which work is being done by industry in the recession.

(iii) In addition to the increase over the planning total the PSBR is also raised by additional debt interest (+£500 million) and also by increased spending arising from pay and price rises (eg defence cash limit increase of £203 million).

(iv) There have been other increases in the volume of programmes arising from decisions. These have been met from the contingency reserve and so do not add to the planning total in Cmnd 7841 or to the PSBR. Major examples include the increases in the EFLs for British Shipbuilders (£65 million), British Steel (£400 million) and British Rail (£40 million).

CONTACT POINT: MR ROBSON 233-8633

H4 CASH LIMITS 1980-81

Factual

(i) The 1980-81 Rate Support Grant cash limit provided for 13% increase in costs between 1979-80 and 1980-81 arising from price increases and new pay awards.

(ii) Other cash limits provided for 14% increase in earnings from due settlement dates as result of new pay awards. On current expenditure other than pay, provision was made for 14% increase in prices between 1979-80 and 1980-81. Somewhat larger provision was made for price increases on capital expenditure.

(iii) There have been 49 changes to cash limits so far this year, giving rise to a net increase of £220 million against a cash limit total of some £46½ billion.

(iv) The main increases to cash limits have been Defence (+ £203 million) Fisheries aid (+ £13 million) and Northern Ireland (+ 16 million). Main reductions have been energy R & D (-£16 million) and labour market services (- £10 million).

Positive

(i) Expenditure this year is not out of control. It is being closely and effectively monitored.

(ii) There have been difficulties on defence, on local authority capital expenditure on housing and on local authority current expenditure. In each case the problems were quickly identified and action taken.

(iii) Cash limits are being respected.

(iv) In general, increases to cash limits have been met from contingency reserve and so within planned levels of public expenditure and PSBR.

/continued

(v) Winter Supplementary Estimates (to be presented to the House on 2 December) have been taken fully into account in the Industry Act PSBR forecast for 1980-81.

Defensive

(i) The increase in the defence cash limit was not charged to the contingency reserve. As a result this fell on the PSBR. The reserve is a control on decisions to add to the volume of expenditure; the increase in the defence cash limit reflected pay and prices and was not an addition to the volume of the programme.

(ii) Local authorities may respond to the witholding of £200 million rate support grant by equivalent extra borrowing. This would mean no benefit to the PSBR. Aim of the witholding arrangement is to give authorities every incentive to reduce spending and so benefit the PSBR.

CONTACT POINT: S A ROBSON 233-8633

H5 NATIONALISED INDUSTRIES' EFLs

Total External Finance

	1979-80	1980-81	1981-82
	£million 1980 Survey prices		
1. Cmnd 7841 revalued	2,700	1700	750
2. Announced change in 81-82	-	-	+620
			1570

Factual

(i) The announced change for 81-82 does not include provision for BSC. This will be announced following receipt of the industry's Corporate Plan. Provision for the remaining industries has been increased by £620 million which reflects the impact of adverse trading conditions at home and abroad, offset by substantial economies in each industry's requirements. Three quarters of this has been met by removal of the standard shortfall allowance (£470 million) asssumed in Cmnd 7841.

(ii) Individual cash limits corresponding to this provision are being separately announced by the CST in a Written Answer PQ (on 24 November).

Positive

(i) The industries have made a substantial contribution to the overall adjustment needed for 81-82. They have been required to secure economies of more than £¼ billion in order to limit their increased provision to that shown in line 2.

Defensive

(i) Investment. The cuts in investment which these economies may involve should be relatively small in relation to the industries' overall spending on investment (about £5,000 million). Their investment programmes have not been cut back with the severity of much of the private sector; on the other hand, it is right that they should take some of the burden of adjustment which would otherwise fall entirely on the private sector.

(ii) Pay A rigid pay assumption has not been imposed on the industries; pay settlements are the responsibility of the industries

/H5 continued

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themselves and will reflect the different circumstances of different industries. Nevertheless individual industries assumption for pay, along with other key assumptions, have been discussed with them and external financing levels have been set on the assumption that each industry will reach reasonable pay settlements this round, broadly comparable with those likely to be reached in the private sector.

Prices

(iii)/In context of general inflation, further rises in NI prices are inevitable, and effects of these are taken account of in the figures. But rate of increase of NI prices is expected to slow down markedly in coming year.

Efficiency

(iv)/ Recent Monopolies and Merger Commission Reports indicate that there may be substantial scope for improving efficiency in the NIs. To the extent that the economies required can be met in this way, reduction in investment or price increases, can be avoided.

(v) Nationalised industries "off course"? Critics at TCSC hearings in spring were right?

We said at the time that the estimates for the nationalised industries external financing requirements were very uncertain, since they depend on trading conditions. But it remains Government's intention to achieve a substantial turn-round in the nationalised industries' financial position.

Questions on individual industries should be addressed to sponsor departments.

Contact point: C R SMALLWOOD 233-3980

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H6 DEFENCE

	£m 1980 Survey prices		
	1979-80	1980-81	1981-82
1. Total programme Cmnd 7841 (revalued)	9290	9616	9942
2. Announced change in 1981-82			-200

Factual

(i) /(Background: NOT FOR USE)

There is a difficulty in expressing the increase in 1981-82 which will result from the cut. 1980-81 baseline is uncertain: it depends by how much MOD exceed their cash limit. For purposes of this announcement we assume in calculating increase from 1980-81 to 1981-82 that MOD stick to the cash limit of £10,492 million, which would give them estimated volume outturn of £9500 million at 1980 survey prices. If, as we privately expect, they exceed cash limit by substantial amount there could be actual decline in real size of defence programme between 1980-81 and 1981-82. But increase in the two years taken together will still be nearly 5%./

(ii) Outturn for current year still uncertain: there is a danger, as has been recognised, that the cash limit of £10,492 million will be exceeded. For purpose of calculating increase (2½%) from 1980-81 to 1981-82 Chancellor has used estimated outturn for 1980-81 which would be consistent with cash limit (£9,500 million at 1980 Survey prices).

Positive

(i) Defence expenditure grew by 3% in 1979-80 and is expected to grow by some 2½ per cent both this year and next.

(ii) UK's performance in relation to NATO 3% target compares favourably with other European allies. UK devotes greater share of national income to defence than any of major European allies. Defence expenditure continues to rise strongly under this Government, in marked contrast to declining trend under Labour.

Defensive

(i) NATO target is to aim at "real annual increases in the region of 3% pa". UK will be doing just that. Many Allies have fallen short of it with much less justification than UK's current economic situation would provide.

(ii) Any cuts affecting defence procurement must have industrial consequences, but defence industries will still be faring better than manufacturing industry in general.

Contact point: C J A Chivers 233-8119

H7 SOCIAL SECURITY

	£ million 1980 Survey prices		
	1979-80	1980-81	1981-82
1. Total Programme Cmnd 7841 revalued	19,272	19,731	20,183
2. Announced change in 1981-82			- 66

Factual

(i) Lines in table do not represent resulting programme. There will be significant likely additions to it in respect of revised economic assumptions - mainly effect of paying unemployment benefits to higher number of unemployed.

(ii) Abatement of public service pensions applies to those pensions linked to the State retirement pension by the 1971 Pensions (Increase) Act. Broadly this covers retired civil servants, NHS workers, teachers, police, firemen, local government officers, judges, MPs and Ministers. Also covered are ex-members of the Armed forces whose increases are made by Royal Warrant. Does not directly affect other public sector bodies of most of nationalised industries.

Positive

(i) Government has kept to its commitment to maintain real value of retirement pension over time. Most of net announced change in 1981-82 is from decision to uprate pensions and other benefits in November 1981 by one percentage point less than movement of prices over that year, to take account of increase in real value of benefits at November 1980 uprating.

(ii) Expenditure on social security in 1981-82 will still be over £20 billion, and increase over 1980-81.

Defensive

(i) Social security programme takes quarter of public expenditure; could not therefore be exempted from need to secure economies.

(ii) Amounts saved are most that could be secured without breaking Government's commitments to pensioners and to protect those most in need.

(iii) Uprating of benefits announced at Budget time and paid from 24 November 1980 was 16½ per cent for most benefits. (This was forecast movement of prices between November 1979 uprating and

continued

November 1980). We now expect prices movement over that period to be 15½ per cent. So there has been an increase in the real value of benefits. We do not expect earnings in 1981-82 to increase as fast as prices. At this time we cannot afford for those out of work to have real advantage over those in work. But Government wishes to maintain its pledge to protect real value of pensions over time. Hence decision to take back 1980 overpayment at November 1981 uprating.

(iv) Those who receive less than full price protection at November 1980 uprating (unemployment benefit, sickness benefit, invalidity benefit and maternity allowance) will be treated in same way as retirement pensioners and others. Decision to abate their uprating was related to the decision to bring them into tax (UB from April 1982, other benefits as soon as possible thereafter). Position will not have changed at November 1981 uprating.

(v) Certain benefits are exempt from the one percentage point. They include war pensions, mobility allowance and attendance allowance. There will be no change in other benefits which are not uprated every year (e.g. maternity grant,death grant etc).

(vi) Decision on uprating of child benefit will be taken at Budget time. Announced changes make no assumption about level of child benefit.

CONTACT POINT: C D BUTLER 233-3932

J1 LABOUR PARTY/TUC

Factual

(i) Labour and trade unions concerned over decline in business activity and high unemployment; blame Government's fiscal and monetary policies as deflationary; expect 3 million jobless next summer (Mr Healey).

(ii) Labour and trade unions say monetary policy too tight; call for reduction in interest rates (Mr Healey: 4% off MLR).

(iii) Labour and trade unions have criticised public spending cuts; call for more spending on industry and special employment measures.

(iv) Labour Party and TUC have urged higher PSBR during recession (Mr Healey: £3-4 billion above PSBR forecasts):

(v) Government accused of using unemployment to moderate pay after exacerbating inflation by own actions (nationalised industry price rises; VAT increase in June 1970; local authority rates and rents).

(vi) TUC Council and some Labour spokesmen favour an incomes policy but Congress in September voted for free bargaining.

(vii) Present over-run on money supply means, on Government premises, rising inflation will re-emerge in 1981/82 while present fall in inflation rate reflects last Government's monetary control.

(viii) Both TUC and Labour NEC call for controls on imports.

Positive

(i) Chancellor's statement re-affirms strategy that economically responsible Opposition members recognised as necessary - at least when in office.

/continued

(ii) Interest rates: See D1

(iii) Inflation now on firmly downward trend.

(iv) Expansion of special employment measures; selective assistance for investment; support for industrial research.

(v) Opposition spending plans were unrealistic.

Defensive

(i) Higher National Insurance contributions. Appropriate for those in work to help finance benefits for jobless and those in good health to pay more towards cost of NHS.

(ii) Public spending cuts: needed to check PSBR and allow monetary targets to be met without excessive interest rates. 6% figure in cash limits not an incomes policy: right to look for much lower growth in public service earnings in the coming year than the recent past. Both are necessary to fiscal policy.

CONTACT POINT: MISS DEYES 233-7426

J2 CBI AND BUSINESS INTERESTS

Factual

(i) Support expressed for Government aims of bringing down inflation and creating conditions for trading sector of economy to flourish. But critical of some details and timing of strategy.

(ii) High interest rates: 4 percentage points off MLR request by CBI President (also West Midlands group of Chambers of Commerce) now reduced to "significant" cut in excess of 1 percentage point.

(iii) High exchange rate: seen as linked with high interest rates and a burden on exporters.

(iv) National insurance surcharge: seen as penalising home products vis à vis imports.

(v) Private sector felt to be bearing brunt of recession. Government is urged to do more to cut public spending, public sector pay and public sector employment and get borrowing down to relieve pressure on interest rates.

(vi) Use of North Sea oil revenues - should be used to finance tax cuts that would benefit business, not to finance living standards.

(vii) Energy costs for UK industry - disproportionate to those in competitor countries.

Positive

(i) Interest rates - see D1.

(ii) MTFS strategy to bring down inflation re-affirmed. Offers best prospect for business in longer term.

(iii) Government determined to keep public spending, public sector borrowing and monetary growth in check. Firm stand on public sector pay.

Defensive

(i) Spending cuts inadequate?

Government still committed to lower public spending in medium term.

(ii) Spending cuts harmful to industry? Excessive public spending and borrowing worse for industry in long run.

(iii) Exchange rate suggestions for direct action misguided. See C1.

(iv) NIS - brings in substantial revenue; reduction would have to be financed from some other source.

(v) Revenue raising from petroleum production and concentration of national insurance increase on employees mean no extra burden on hard pressed sector of private industry.

(vi) Energy Costs

Government willing to discuss energy price anomalies with fuel industries and press other Governments to eliminate any energy subsidies. But energy prices must reflect marginal costs of supply.

Contact Point: Miss M M Deyes 233 7426

J3 POVERTY/CONSUMER PRESSURE GROUPS

Factual

(i) Child Poverty Action Group and others argue against reducing real value of social security and/child benefit.

(ii) National Council of Voluntary Organisations want expanded programmes to help young and long term unemployed; last report from Supplementary Benefits Commission predicted social conflict.

(iii) Low Pay Unit and others continue to worry about numbers depending on low incomes from work, and likely to lose jobs.

(iv) National Consumer Council wants ceiling on nationalised industry price rises.

Positive

(i) Inflation coming down; this is especially important to worst-off: Chancellor's statement affirms strategy to achieve lasting reduction in inflation.

(ii) Increase in pension this week 16½%; we now expect November 1979 to November 1980 price increase to be 15½%.

(iii) Defeating inflation essential for strong economy, more jobs, higher incomes and wealth creation to finance support of families, pensioners etc.

(iv) Measures to help young and long term unemployed expanded.

Defensive

(i) Next year's increase in pensions one percent under expected price rise: justified by this year's up-rating one percent above actual price rise.

(ii) National insurance contributions increase: see G1. Frank Field (former CPAG director) conceded in recent letter to Financial Times right for workers to pay more towards financing benefits for jobless.

(iii) What about child benefit? Wait for the Budget.

(iv) Nationalised industries: some price rises inevitable but rate of increase should be slower in coming year.

Contact Point Miss M M Deyes 233 7426

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J4 CONSERVATIVE PARTY CRITICS

Factual

(a) Some critics want more curbs on public sector spending, especially pay, to bring down PSBR (Mr Critchley, Mr Higgins, Mr du Cann).

(b) Some concerned about industry and unemployment urge relaxation of monetary policy and lower interest rates (Monday Club Mr Rippon, Mr Heath). Mr Macmillan in TV interview called for some reflation.

(c) Some concerned about effect on industry of high exchange rate (Mr Lewis, Mr Dorrell, Mr Baker, Mr Higgins). Tory Reform Group paper calls for "balance of payments policy".

(d) Some criticise form taken by spending cuts (Mr Rippon wants concentration on current spending Mr McCrindle wants to save social services even at a cost of raising taxes; Mr Churchill critical of defence cuts).

(e) Many critical of suggestion of raising taxation; Mr Latham wants tax cuts to boost demand and encourage pay moderation: Mr Latham and the two Pattens want cut in NIS

Positive

(i) Interest rates - see D1

(ii) MTFS strategy to bring down inflation reaffirmed.

(iii) Government determined to keep public spending, public sector borrowing and monetary growth in check.

Defensive

(i) Suggestions for action on exchange rate remain misguided - See C1.

(ii) Revenue raising from petroleum production and concentration of national inusrance increase on employees mean no extra burdens loaded on hard pressed sector of private industry.

(iii) Defence spending still rising strongly. UK meeting NATO target.

Contact point: Miss Deyes 233-7426

Econ Pol Strategy

cc J. Vereker.

Covering SECRET

Prime Minister

The Chancellor will be considering this draft further over the weekend. It includes all the points agreed at the monetary seminar, including the extension of Treasury bonds. I don't see how it can be much shorter. Do you have any comments at this stage?

TL

20/11

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

20 November 1980

T.P. Lankester, Esq.,
No.10, Downing Street

No - except - please don't announce another M.! We are already having trouble with M3.

Dear Tim,

END NOVEMBER ANNOUNCEMENT

The Chancellor thought the Prime Minister might like to see the current draft of the complete statement he will be making on 24 November. The text is, of course, still very much subject to amendments of presentation and style; but the material to be covered has now broadly been settled. The Chancellor is minuting separately about the public expenditure section, with a view to clearing the detailed points with the other Ministers concerned, in accordance with the Cabinet conclusions on 19 November (CC(80)41st Conclusions, Minute 5).

Yours

John

(A.J. WIGGINS)

why do we not announce the RSL ?

Spoken to Treasury about this.

TL

END NOVEMBER STATEMENT (Draft of 20.11.80)

Monetary Policy

A1. At the time of the Budget I said I would consider this autumn the roll-over of the monetary target of 7% to 11% set for the period from February 1980 to next April. I have now done so in the light of monetary developments and developments in the economy generally. I am publishing the latest economic forecast today as required by the 1975 Industry Act.

A2. Although inflation is now falling rapidly monetary growth seems likely to overshoot the current monetary target. Recent statistics have, however, been bedevilled by distortions apparent since June when we abolished the corset imposed by the previous administration. The overshoot will certainly be less than the figures for the period so far might suggest. I expect growth to slow down in the rest of the target period, particularly in the New Year when the public sector moves into surplus. There are also signs that bank lending may now be starting to slow down.

A3. In these circumstances, I propose to maintain the present monetary target range for the rest of the target period. I shall take account of any excess monetary growth this year when I announce a new target in the Budget together with whatever further measures are necessary to ensure that the thrust of the medium-term financial strategy is maintained.

[A4. (A) The Treasury and Bank of England have now completed consultations on more effective methods of monetary control. The time between now and the Budget will be used to bring about a number of improvements in monetary control techniques.

A5. (A) First, consultations on new arrangements for prudential liquidity will be brought to a conclusion so that the reserve asset ratio, which impedes monetary control, can be phased out. Second, the Bank of England will open up discussions on the way it conducts its money market operations and lender of last resort facilities. Third, I am considering further steps which can be taken to put overselves in a position to evaluate the properties of base money and how it would fit in with our medium term objectives for wide monetary aggregates such as £M3. These include [examining alternative sources of income for the Bank and] collecting and publishing a new monetary series for retail deposits (M2). Fourth, we shall continue to take steps to sell more Government debt direct to persons. I shall therefore further extend the eligibility for index linked certificates so as to attract at least £3 bn next year. I shall explain these steps at greater length in the debate on Thursday.]

OR

[A4. (B) The Treasury and the Bank of England have now completed consultations on more effective methods of monetary control. I shall explain in my speech in the debate on Thursday how the time between now and the Budget will be used to make a number of improvements in monetary control techniques.

A5. (B) I shall also continue to take steps to sell more Government debt direct to persons. I shall, therefore, extend the eligibility for index linked certificates so as to attract at least £3 bn next year.]

Is it necessary to announce M2?

Separate ~~[illegible]~~ copy of this section attached to minute on public expenditure. TL.

Public Expenditure

As hon members will know, the PSBR during the first half of 1980-81 is estimated to have been about £8½ b

B1. I expect the PSBR to be much lower in the second half of the financial year, but it could be around £11½ bn for the year as a whole. [Much] of this is due to the effect of the recession, particularly on public expenditure.

B2. We have reviewed public expenditure plans for 1981-82. In conditions of continuing recession in the UK, some increases in expenditure arising from the recession must be expected and planned for. However, the total increase in expenditure and in public borrowing must be consistent with the medium term strategy and with a continued reduction in inflation. That is essential for a resumption of sound sustainable growth.

B3. It is realistic to assume a higher level of spending on unemployment and other benefits this year than allowed for in the White Paper of last March. The changes in trading conditions are reflected in the external financing limits for the nationalised industries for 1981-82 which, excluding steel, are being announced separately [today]. These industries are being required to secure substantial economies.

B4. My rhf the Secretary of State for Employment announced last week extension of the special employment measures which will cost nearly £250 million next year. The Government have also decided to increase the provision for selective assistance for investment and support for industrial research and development at a cost of £50 million next year. These amounts, and the other public expenditure changes I shall mention, are in the 1980 survey prices at which the decisions have been taken - that is broadly the prices of a year ago.

B5. In view of these increases, we must now plan to cut the volume provision for the majority of spending programmes. We must also restrict the cost, and so the cash requirements, of the public sector. Our aim is to hold the planning total for the volume of public expenditure in 1981-82 below the outturn now expected for 1980-81. The latter is some £[1] billion higher in volume than envisaged at the time of the last White Paper. I am publishing in the Official Report [and making available in the Vote Office now] a summary of the effect on expenditure programmes in 1981-82 of these decisions. Details of these changes, and of the changes in the provision for later years, will be set out in the public expenditure White Paper to be published at the time of the Budget.

B6. I should mention some of the main changes. We must, like some of our other NATO allies, adjust the rate of growth of our defence expenditure. Planned expenditure in 1981-82 will now be £200 million less than allowed for in the last White Paper. This will be nearly 8% higher than the level achieved in 1978-79.

B7. In broad terms, we shall be seeking a 3% reduction in the volume of local authority current spending compared with the level we planned for this year. We also propose to calculate the Rate Support Grant on the basis of providing a lower percentage of the reduced volume than the 61% (for England and Wales) in recent RSG settlements. My rhfs the Secretaries of State for the Environment, Scotland and Wales will be consulting their local authority associations on these proposals before the RSG settlements next month.

B8. In 1980 prices have increased less than we allowed for when we decided on the uprating of social security benefits for this November. There will accordingly be some increase in real value of benefits. We intend that the increase in retirement pensions and other benefits in 1981 will be such that the excess adjustment over prices, estimated at one percentage point, is not carried forward into future years. This will maintain the real value of the retirement pension over time. Public service pensions will be treated in the same way. Any further action on index linked pensions will follow the report of the Scott Enquiry. A decision on child benefit uprating will be taken at the time of the Budget. We have also decided that the earnings rule limit will remain unchanged.

B9. But the cost of public expenditure programmes, especially pay, is as important as volume. It is essential to our fiscal policy, and fair, to look for a much lower growth in public service earnings in the coming year than in the recent past. It has already been announced that the Rate Support Grant limit will allow for a 6% annual increase in earnings from due settlement dates in the current pay round. It will provide for an increase in prices other than pay of 11% between the average levels for 1980-81 and 1981-82. Expenditure in other parts of the public services will be subject to broadly the same financial disciplines.

Revenue

C1. I have also been giving consideration to the revenue requirements for financing next year's expenditure. I am determined that the size and composition of the PSBR in 1981-82 should be consistent with the Government's monetary strategy. The main fiscal decisions must await my Budget. But if we are to secure a full financial year's revenue, given the lead times involved, some decisions are necessary now.

C2. For that reason this is the time of year when we review and announce changes in National Insurance Contributions. We have concluded that an increase in employees' contributions would be appropriate.

C3. In the first place, we propose that the employees' contributions are increased next year by a quarter per cent to take account of prospective demands on the National Insurance Fund.

C4. Second, in order to maintain the planned level of health services, we propose that the health element of the national insurance contribution should be increased for employees by a further quarter per cent.

C5. Third, national insurance contributions do not pay for the whole of contributory benefits. Moreover, non-contributory benefits are financed entirely by the government outside the NI Fund and have been growing rapidly. We think those in work should directly shoulder a larger share of the cost of contributory benefits. We propose therefore to reduce the Treasury Supplement to the Fund from 18% to 14½%. This will be offset by a further increase in employees rates of half a per cent.

C6. The combined effect of these changes will increase national insurance contributions from employees by around £1 billion in 1981-82 and increase the employees' rate, from 1 April 1981, from 6¾% to 7¾% on earnings between £27 pw and £200 pw. Other rates and levels will also change. Having regard, however, to the financial pressures on industry and the way the employer's share has grown in recent years, we shall not make any increase in employer's contribution rates. Full details are set out in the Government Actuary's Report and my RHF the Secretary of State for Social Services is introducing the necessary legislation.

C7. Since March there has been time to assess more fully the implications of the steep rise in the price of oil since 1978. This has been on a scale as important as that in 1973-74. The Government have concluded that there is scope for a further increase in oil taxation. The Inland Revenue are setting out further details of what I am about to announce in a press notice and will be inviting the industry to hold immediate consultations with them.

C8. Petroleum Revenue Tax - because of the way reliefs are structured - does not provide an adequate means of obtaining further revenue. I shall therefore introduce in the next Finance Bill a supplementary tax to be paid in addition to PRT, to take effect from 1 January 1981. The new tax will be charged at a rate of [20%] on gross revenue less an allowance. It will apply to fields which are in production whether or not they are yet liable to PRT. It will be deductible in calculating petroleum revenue tax and corporation tax.

C9. We are also examining the scheme of PRT reliefs and any changes, which will take effect from the same date, will be included in the next Finance Bill.

C10. I do not believe the changes will deprive companies of a fair return on their North Sea projects and exploration. They will together yield around £1 billion in 1981-82, mostly from the new tax.

(Switching resources from the personal sector to the manufacturing sector).

Interest Rates

D1. Until monetary growth has been brought back under firm control, it would be wrong to consider a substantial reduction in interest rates. But the changes which I have announced should leave no room for doubt about my determination to control the PSBR and to ensure that manufacturing companies are not unduly penalised. The growth in £M3 and the wider monetary aggregate is expected to decline in the new year. Inflation is already coming down and has fallen below the current level of short-term interest rates. And the narrower aggregates, which have particular relevance to short term interest rates are performing satisfactorily; I have therefore concluded that some reduction in MLR is possible. The Bank of England is, with my approval, announcing a reduction in MLR of 2 percentage points this afternoon.

Note

[This section copied only to:

Chancellor
Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Britton

PS/Governor]

J B Unwin

20 November 1980

CONFIDENTIAL

10 DOWNING STREET

20 November,1980

ECONOMIC STATEMENT

I mentioned to you this morning that, in preparation for the meeting that you and I and Bernard Ingham will have with the Paymaster tomorrow at 11.00 am, I would be circulating to all the participants an early draft of the guidance that the Paymaster might send out to his colleagues immediately after the Chancellor speaks next week. I am sure the Paymaster will want, at his meeting, to consider the questions relating to media treatment on the day - and you undertook to let us have the latest draft of the Chancellor's statement - but I think we should also prepare carefully for the way in which other Ministers are going to put across the extent to which the economic strategy is still in tact.

I therefore enclose a draft, which cannot of course be finalised until next week. For obvious reasons I have not been specific on the subject of interest rates, and the draft will have to remain confidential until all the announcements are made.

JOHN VEREKER

Mrs R Gilmore,
HM Treasury

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DRAFT

WHITHER THE STRATEGY?

Objective

The Chancellor's statement on /25/ November has naturally aroused considerable public interest not only in the short term measures, but in the whole direction of the Government's economic policies. It is important to reaffirm that the fundamental objectives are unchanged, and that the Government is working in the framework of a coherent strategy, rather than reacting to problems as they arise. This note is therefore designed for use by Ministers in all their speeches, broadcasts and writing this week and in the weeks to come.

Presentation

The objectives of Government economic policy are unchanged. They are to achieve a permanent reduction in the rate of inflation, and to create the conditions for a sustainable growth of output and employment.

In order to achieve these objectives, the Government published, at the time of the last Budget, a financial strategy. The key elements in that strategy were control of the money supply, and a reduction in public expenditure.

We said that the annual growth of money supply would be reduced to about 6 per cent in 1983-84; and we suggested some ranges for annual growth between now and then. There is

/no

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no doubt that so far there is more money in the system than we intended. But we are confident that the largely technical factors which led to that will not be operating in the future; and that we are still on course for our target in 1983-84.

And we said that public spending would fall each year between now and 1983-84. As the Chancellor indicated last /Tuesday/, it will still be lower next year than this, but the fall is not as great as we had intended. That is because we are moving into the worst international recession since the war, from which Britain is suffering particularly badly. At such a time large elements of public spending, such as social security payments and support for nationalised industries, are bound to rise.

Despite these difficulties over the money supply and public spending - and let us be frank about them, the difficulties have been more severe than we expected - we are making good progress towards our objectives.

Inflation is coming down nicely - faster than most people expected. Prices have risen by less than 1% in each of the last six months, and we expect the rate of inflation next year to be not far above single figures.

/Wage

Wage settlements have moderated substantially. The figures published last week, of the increase in average earnings in the year ending in September, do not at all reflect the new climate of realism we have seen this autumn. In fact, the CBI estimate that a clear majority of the settlements in manufacturing industry this pay round have been in single figures. As for the public sector, we have told local authorities that we are making available only enough money to finance a 6% increase in their pay bills; and the Prime Minister has confirmed that the rest of the public service will be subject to the same sort of financial discipline.

And because we are confident that the money supply is now under control, we have been able to give the stimulus to output and employment that we have always said we would when the time was ripe, by bringing interest rates down a full /‾ _/ %.

The Outlook

The way ahead is not an easy one. We shall be suffering even worse from the recession in the first half of next year. Unemployment is bound to rise still further. Living standards are bound to fall, even for those who are still employed.

/But when

But when the upturn comes - and this recession, though deeper than others, will like all recessions end in a period of growth - the conditions for a sustainable period of increasing production and increasing employment will be there. Above all, inflation will simply not be let loose again. The era of unrealistically large pay settlements will be behind us.

Responsible pay bargaining isn't just a sacrifice that everyone is being asked to make this time round. It is an essential ingredient of our ability to seize the opportunity that the end of the recession will bring. Never again must people generally expect to be paid more and more pounds carrying less and less purchasing power. Stable prices, more jobs, and increased prosperity are within our grasp if we don't let greed overcome commonsense.

E.R.

20 November 1980 PM
Policy Unit

PRIME MINISTER

I attach a copy of an article in yesterday's Guardian by Peter Jenkins.

Peter Jenkins is no friend of course, but the article is not a bad summary of the position as it must appear to neutral or hostile observers

The main omission in the article is the real joker in the pack - the very rapid rise in oil prices and thus the completely unforeseen combination of excessively steep recession and an excessively high pound; this whole structural adjustment being forced at tremendous speed on the least competitive, most under-invested and historically trade union-ridden segment of the economy. It is this change, on top of the huge growth in earnings over our first year, that has really pushed us off course.

We must now be approaching the point - probably about the time of the March Budget - when we have to choose between one of two routes. On the one side, we can start to move increasingly towards what is "politically possible" but simply inadequate for solving the problem. On the other, we will have to find ways of doing things which appear to be "politically impossible" but which are essential if we are to have the slightest chance of getting back onto our strategic course.

We are at present keeping 8 and 9 January free to do a reappraisal of the position and our strategy, with Alan Walters (at Chequers) I have already had some discussion with him on this and we have been communicating on different aspects of the problem. We shall be giving you a paper, with copies to Geoffrey and Keith, shortly before the Christmas Recess in preparation for that January session (whether or not you decide that you would like Geoffrey and Keith to attend it). The aim of the paper will be to ensure that we see the wood for the trees while there is still time left to think it through. There's no point in putting it to you earlier, because I don't think there's time to digest that type of paper except during the Recess.

JH

JOHN HOSKYNS

The collapse of confidence

Peter Jenkins

THERE IS as yet no major change in Government policy. The new session of Parliament opens tomorrow with Mrs Thatcher as determined as ever to solve the problems of Britain through control of the money supply.

In the course of the public expenditure review, which the Cabinet is supposed to finalise this morning, the Treasury ministers have suffered some reverses and the "wets" — for the first time — scored some points. But what the Treasury failed to obtain in spending cuts it intends to claw back in tax increases in the Budget next spring. In other words, the recession will be made still worse by policies of deflation in pursuit of the Government's monetary targets.

The Prime Minister has rejected an early reduction in interest rates. They are to come down only as the money supply is brought under control. She is more favourably disposed to a devaluation of the pound if only she knew how. This debate continues in Whitehall but there doesn't seem to be much which can be done about the pound for as long as the Government sticks to its monetary strategy.

So there has been no change of direction during the last two or three weeks, in spite of all the leaks, in spite of the divisions within the Cabinet and the screams from industry. Nevertheless, something important has happened and Mrs Thatcher's Government, after 18 months in office, has perhaps entered a new phase.

The first thing that has happened is a collapse of confidence in the Chancellor of the Exchequer and his Treasury team. This applies to Number 10, the Cabinet and official Whitehall, although for somewhat different reasons. The Prime Minister's loss of confidence in her Chancellor has chiefly to do with his failure to control the money supply. That, in her simple view, is what he is there to do.

The Cabinet has lost patience with the Treasury because it is sick of forecasts and figures which either turn out to be wrong or seem to be irrelevant; moreover, it has little remaining confidence that Sir Geoffrey Howe knows where he is heading, except for trouble. Whitehall's lack of confidence has to do with the lack of confidence which Treasury officials (or most of them) themselves have in the Chancellor's policies.

The second important change to have occurred is an erosion of confidence in the Government's policy in a wider sense. The Prime Minister herself, or so it is said, is becoming afflicted with mild scepticism about at least the timing of the dawning of the entrepreneurial renaissance which is supposed to be the result of her monetarist stringency. But that hasn't yet diminished her enthusiasm for the monetarism.

Sir Keith Joseph, who is charged with the benign neglect of British industry, is said to be down in one of his dumps; something has gone wrong, the country is failing to respond to the Government's logic.

Industry's lack of confidence in the Thatcherite policies is having a powerful impact on the Government and, no less significantly, on backbench Conservative MPs. Sir Terence Beckett's political ineptitude ought not to obscure the importance of this. The concern focuses not primarily upon the alarming trend in unemployment but upon the exchange rate, and on interest rates primarily because of their connection with the over-valued pound. How much punishment of this kind can industry take and — still more to the point — what good will it do in the end? Those are the questions Ministers and MPs are increasingly asking.

The trouble is nobody can pretend to see light at the end of the tunnel. All those who peer into the future without the aid of blue-tinted spectacles are becoming rapidly convinced that it doesn't work. This is the third important change in the atmosphere brought about by the mind-concentrating public expenditure review of the past few weeks. For there seemed to be no end to the remorseless logic of the Treasury. Where would it lead the country — and the Government — in, say, two years' time? To three million unemployed? Disorder on the streets? Suppose inflation bottoms out at 8 or 9 per cent in 1982 — would that be a sufficient basis for a competitive surge by British industry? And how long before unions and employers between them eroded whatever advantage has been so painfully gained?

These realisations have produced what is not yet a change of direction in the Government's policies but the beginnings at least of a crisis of confidence. There are too many Ministers now who know in their hearts that Thatcherism doesn't work and this dawning of disbelief is of far greater potential importance than any observable shifts of emphasis which are likely to emerge from the recent round of Cabinet battles.

Although the "wets" inflicted some humiliating blows against the Treasury it would be wrong to suppose that the rival faction in the Cabinet has gained the upper hand or that the counter-revolution has begun. All that has happened so far is that some commonsensical Ministers — mostly from outside the great spending departments — have prevented the Treasury from pushing its logic to its looney extreme.

The overshoot in public spending has three chief causes. One is the cost of the nationalised industries. For example, each man employed in the steel industry is currently costing the exchequer £7,000 a year.

Another is the cost of the recession. For example, every man unemployed costs the tax payer more than £4,000 a year. Thirdly, defence spending has gone over the top this year for the perverse reason that weaponry is being delivered in advance of time, that also due to the recession. These three items alone add a gigantic sum — in excess of £3 billion to Government spending.

The Treasury — determined to stay within the borrowing limits dictated by its monetary strategy — sought off-setting economies in the narrowing base of controllable public expenditure. That would have meant rubbishing election promises, deepening the recession and exacerbating social distress. The Cabinet, in the end, prevented the Treasury Ministers pushing their policies to such dangerous political extremes, but no coherent alternative strategy for combatting inflation is as yet in sight.

A fundamental change in the direction of Government policy is not yet in prospect. One reason for this is that Mrs Thatcher still has time on her side. The prospects for the coming wages round are good; the retail price index (which measures inflation) is the only one flashing an encouraging sign; workers are behaving cautiously and household incomes have not yet felt the impact of the recession. Mrs Thatcher has at least one more winter of her honeymoon.

The hue and cry about spending cuts, the alarming trend in unemployment, and the headlines of economic gloom and doom have between them obscured an important fact about the present state of Britain. This is that real living standards are only now beginning to be hit by the recession. During 1978 and 1979 real disposable income (that is money to spend after tax, deductions and price increases) rose by a cumulative 12 per cent. Only in the third quarter of this year did a decline set in. North Sea oil and inflationary wage bargaining have so far cushioned the British standard of living against the effects of the sharp increase in world energy costs.

It is no great wonder therefore that the Government is less unpopular than might be supposed, that many groups of workers are prepared to accept modest wage settlements, and that there is as yet no general sense in the country of the impending crisis which is beginning to grip Ministers and their senior officials.

The unemployment time bomb already has some time to tick. With more than two million out of work already the total, according to official forecasts, could rise to 2.7 million by this time next year and — perhaps — three million by 1982. Yet it is misleading still to talk about "mass" unemployment just as it was in the Thirties;

So Mrs Thatcher has some leeway yet. What is worrying many of her Ministers is not so much the immediate consequences of her still-determined persistence but rather where it may have led her in a year or two's time. The recession in Britain is worse than anywhere else because of the greater underlying weakness of the British economy. Persistent slow growth combined with inflationary wage pressures and resistance to structural change have progressively enfeebled the British economy. Without North Sea oil the crisis would by now be deep and fundamental.

In such an atmosphere it was never likely that the Thatcherite free market magic would bring about the rapid change in attitudes and performance expected of it. What at the time of her election seemed like an innocent enthusiasm now seems like a risible delusion. Mrs Thatcher being Mrs Thatcher she intends to press on.

But how will the damage done to British industry be repaired? How will the economy climb out of a recession so deep? Who seriously supposes that the sustained wage restraint necessary to restore British competitiveness will be forthcoming? Who can believe that a spontaneous industrial regeneration will result from the policy of squeeze, squeeze and squeeze again?

In the last few weeks an apparition has appeared at the end of the tunnel. It is not the glimmer of light but rather the dark spectre of failure. It has been a chilling experience for those who have seen it.

PROGRESS IN THE SOCIAL SERVICES

Objective

This note provides material for Ministers to draw on in their speeches, broadcasts or writing, designed to soften what is perceived by some as the hard faced image of the Government, an image which is not helpful in encouraging responsibility in pay behaviour. It is for use at any time with all audiences, but since it is based on a speech delivered by the Secretary of State for Social Services on 7 November, it should not be repeated word for word.

Presentation

Despite the cuts we are having to make in some parts of the social services, we have a lot of positive achievements to our credit. If you listen only to our critics, you would think that we had done nothing but cut, cut and cut again.

Of course, the battle against inflation has to be our top priority; and of course, since the social services are the biggest single chunk of public spending, they cannot be shielded from the need to find savings. But if the country is to make a fair judgement on our record, it is to the facts that they should look, not the myths.

Spending more

Did you know, for instance, that this Government is today spending more, in real terms, on the National Health Service than was spent in any year of the last Government?

Did you know, for instance, that local authorities seem likely, as a whole, to be spending more on social services than was spent in the last year of the last Government?

Increased pensions

Did you know, for instance, that last year's increase in pensions was the biggest ever in our history, and that this month pensioners will be getting another increase which will improve their standard of living still further?

But of course it does not stop there. We are pressing on with the

/policies

policies on which we were elected.

Less Bureaucracy

In the Health Service, we promised less bureaucracy. Already, the instructions to achieve this have gone out to the Health Service, and by April 1982, the Area Health Authorities will have disappeared. We shall have stronger leadership at the local level, and eventually up to 10 per cent of administration costs will have been switched into direct patient care.

As promised, we have ended the vendetta against independent medicine which will now be allowed to grow to meet the rising demand for private health care.

Voluntary funds flowing in

We have lifted the ban on Health Authorities appealing for voluntary funds, and the money is beginning to flow in.

Starting with the Elizabeth Garrett Anderson Hospital for Women, we are saving many a small local hospital threatened with closure.

We are taking a much firmer line on what to do in industrial disputes in the NHS. We have implemented a new procedure for settling local disputes quickly, and without disruption.

Waiting lists down

And the result of all this so far? The answer - hospital waiting lists are now down by nearly 100,000 since the Election, compared with the increase of a quarter of a million under the last Government.

And all the time, new measures are helping vulnerable people.

Last December, we announced special arrangements for hostels for alcoholics.

We have launched a new campaign to eliminate rickets among immigrant communities.

We have speeded up transfer of patients from the special hospitals

/ (like

(like Broadmoor and Rampton) to normal mental hospitals in the NHS.

We have resolved the long running dispute between doctors and pharmacists about dispensing medicines in rural areas.

We have maintained in full our cash help for voluntary bodies working in the social services field - now over £7 million a year.

We have revised the advice to doctors about giving contraceptives to under-16s, stressing the importance of sustaining family links and responsibilities.

New kidney donor card

We have launched a new campaign to encourage people to carry a plastic kidney donor card, and a new card for other organs.

We have set in train a review of dental health policy, where greater emphasis will be placed on preventive care.

We have given new guidance on preventing child abuse.

We have launched an initiative, with the doctors, to secure more effective prescribing of drugs.

And so it goes on - a steady record of progress and improvement in our Health and Social Services.

Social Security

But what about Social Security, you may ask? Surely there you have had to make cuts?

The answer is "Yes" - we have had to make some cuts. One cut is in benefits, like unemployment benefit, which everyone agrees should be included in taxable income, but which are not yet taxed. Another was the cut in benefits for strikers' families.

Help for the most vulnerable

But we have done our best to help the most vulnerable.

/ Almost the first

Almost the first thing we did after taking office was to extend mobility allowance to 30,000 more disabled people - ahead of Labour's programme.

War Widows' Pensions have been freed from tax.

The Christmas Bonus has been made statutory.

An extra £100 million is being spent on help with fuel bills.

Child benefit for one-parent families is being increased by 50 per cent; Family Income Supplement is being doubled.

Social Security simplified

This month, the first stage of a major simplification of social security comes into effect. The system will be easier to understand and simpler to run. Claimants will, for the first time ever, get written statements of how their benefit is calculated. As part of this change, we are giving more help to needy families with children, to one-parent families and to the disabled on supplementary benefit. In future, they will become entitled to the long-term rate of benefit after one year, instead of waiting for two.

Maternity grant is to be made "non-contributory" - and so will be extended to many young and "at-risk" mothers.

We have removed VAT from cars provided for severely disabled people by the charity "Motability".

By the end of this month, mobility allowance will have been increased by 45 per cent since the Election.

For the future, we have published proposals for reforming the industrial injuries system. We have published proposals for streamlining the payment of short term sickness benefit, by putting the responsibility on employers in return for a reduced National Insurance Contribution. This will save 5,000 civil servants.

We have published a discussion document about National Insurance contributions and benefits for the self employed.

/ For the

For the first time ever in the history of National Insurance, we are consulting the public on the future of Maternity Benefits.

So you will see that social services are not just a matter of cuts, cuts and yet more cuts. Yes, we have to play our part in making the economies needed to get British industry back on its feet. But that does not mean an end to progress. On the contrary, it makes the kind of progress we all want to see even more important.

Paymaster General's Office
20 November 1980

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

19 November 1980

T.P. Lankester, Esq.,
Private Secretary,
10, Downing Street

PM agrees

MG.

INDUSTRY ACT FORECAST

The Prime Minister will be aware that the Industry Act (1975) requires the Government to publish economic forecasts twice a year. The Chancellor will therefore be putting out on 24 November with the other supporting documents a press notice on the forecast, the format of which is very much the same as a year ago.

As you know, the Chancellor has no enthusiasm for publishing forecasts, particularly if they bring little cheer. The Treasury Committee has been pressing him to publish more than at Budget time and we shall be going a little way to meet them - on manufacturing and North Sea output, and on world trade. These parts of the forecast have, in one form or another, been published before.

..... I attach the main table from the press notice: this is the part of the forecast that usually receives the most attention in the press.

So far as prices are concerned, the forecast envisages a further substantial reduction in the inflation rate from 15½ per cent in the fourth quarter of this year to 11 per cent in the corresponding quarter next year. The Chancellor has considered whether, in view of recent good progress on the inflation front, a lower forecast could be justified. The text will make clear that single figure inflation by the end of next year is by no means ruled out; but in view of the fact that we are unlikely to have this year's favourable (so far as inflation is concerned, but not from the standpoint of industrial profitability) factors - an appreciating exchange rate and declining profit margins - repeating themselves, the Chancellor thinks it would be better to stick with the figure which has already been agreed for the non-pay elements in next year's cash limits. He notes that a new forecast, which could present a more favourable inflation picture if intervening developments warrant this, will have to be published with the 1981 Budget, and that the size of the next social security uprating will depend on that forecast.

/The other

The other main features of the forecast are as follows:-

(1) no further fall in output from existing (i.e. end 1980) levels and some possibility of the beginnings of recovery;

(2) some fall - unspecified - in the PSBR in 1981-82;

(3) continuing surplus on the current account of the balance of payments.

Yours

John

A.J. WIGGINS

TABLE 1: ECONOMIC PROSPECTS TO 1981

	Percentage changes 1979 to 1980	Percentage changes 1980 to 1981	Margins of error for 1981 forecast per cent
A. OUTPUT AND EXPENDITURE AT CONSTANT 1975 PRICES			
Gross domestic product (at factor cost)	- 3	- 1½	1½
Consumers' expenditure	0	- ½	1½
General Government expenditure on consumption and investment	- 1	- 2	1½
Other fixed investment	½	- 4½	4
Exports of goods and services	1	- 3	3½
Change in stockbuilding as a percentage of GDP	- 4½	1	1
Imports of goods and services	- 3	0	2½

B. BALANCE OF PAYMENTS ON CURRENT ACCOUNT	1980	1981	
	£ billion		£ billion
	2	2	2

C. RETAIL PRICE INDEX	Percentage changes		Per cent
	4th Quarter 1979 to 4th quarter 1980	4th Quarter 1980 to 4th Quarter 1981	
	15½	11	3

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CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Middleton

Thank you: I have not formed a final judgment yet. Clearly the arguments need to be v. carefully consd.

POLICY OPTIONS

I agreed with the general drift of your discussion at No 11 on 11 November, and support the idea of an early reduction in MLR. However the reasons which how lead me to do so are perhaps worth recording, even though I have not had the opportunity to put them down very succinctly.

2. Douglas Wass's cover note suggests (para 3 of his Guy Fawkes' day minute) we need to begin by establishing the problems to be resolved. I would suggest that there are two. Present conditions threaten to make dangerous nonsense of the Government's commitment to controlling the money supply, and in the near future at that; and looking further ahead they pose an equally serious threat to the MTFS. There are, of course, plenty of other difficulties in the economy which are crying out for resolution. But they are of secondary interest at the moment.

3. Douglas asks (para 5) whether present policy is too severe, given the objectives set and the costs entailed. My answer is, unequivocally, "yes". I suspect that, had we been armed with a plausible and up-to-date medium-term assessment, his might have been too. He suggests (para 6) that business conditions, as they have evolved this year, are not significantly more serious than we expected them to be at the time the MTFS was set. That may be so in terms of trade and consumer's expenditure, but surely not in other respects. For example,

- the real exchange rate is way above the projected level;

- the company sector deficit is worse than anticipated;

- the growth of Bank lending to the corporate sector has been far greater this year than was forecast by earlier NIFs and, it would seem, than our expert friends in the Banks (eg H Rose) foresaw;

- the opportunities available to Government to relieve industry's problems have, at the same time, diminished.

4. The political pressures associated with present policies and circumstances and a prolongation of both are going to get much greater. I am not referring to Sir T Beckett and the more emotional part of the CBI, but to a growing body of quiet and responsible critics. This observation proves nothing of itself. But if the policy is threatened with unviability in any case, then it matters a great deal.

Interest Rates and Monetary Control

5. I have been worried for some time that we have been underestimating the significance of the "distress borrowing" phenomenon. For a long time I felt, however, that this would be basically a short-term influence and that the restraining effect of high interest rates on the demand for credit, would win out after an acceptable time lag (eg by now). This no longer seems plausible, and my presumption is that such a restraining influence is unlikely to offset the growth of distress borrowing in a remotely acceptable timescale in present conditions.

6. I believe that circumstantial support for this view comes from the errors of successive NIF forecasts of company borrowing. If, as I gather from Mr Riley, these have underestimated company borrowing by "several billion pounds", then behaviour is clearly changing, and one ~~or~~ both of two things must be happening:

(a) interest rates are having less restraining influence than the traditional NIF equations suggest they used to;

(b) some other influences on the demand for credit are more influential than the equations recorded them as being; and/or new influences are coming into play. The "distress" phenomenon is the obvious candidate.

7. I gather that the forecasters have, understandably, been searching for statistical relationships which "explain" the recent behaviour of company borrowing more satisfactorily. Their latest equations succeed in doing this and, moreover, suggest that the interest rate remains a dominant influence in restraining the growth of credit. However my impression is that the new equations cannot be taken at face value, and may be compatible with the hypothesis that distress borrowing or other related influences have become much more important. This note being no place for the exposition of technicalities, the important point to stress is that the equations (both old and new) in the model may be misleading.

8. Looked at in a more abstract way, there is no general reason to believe that normal borrowing behaviour and sensitivity to interest rates should prevail today. The crucial issue is simple. In conditions of respectable profitability, buoyant demand, and relatively high stock levels, it is fairly evident that the bulk of firms can respond to the rising cost of interest payments by a variety of different means - cutting stocks, overheads, unprofitable product lines and so on. The more difficult conditions get, the less the room for manoeuvre left, and the more likely that desperate firms will borrow to pay interest or, when that is no longer possible, go out of business completely. It follows from such an analysis that one would predict an increasingly important degree of interest-<u>in</u>sensitivity in companies as a whole as general economic conditions deteriorate and, beyond a certain degree of economic misery, the markedly perverse relationships postulated earlier. Such thinking seems to be implicit in Mr Burns' observation at your 11 November meeting to the effect that yet higher interest rates would be unlikely to lead to a reduction in company borrowing below what it might otherwise be.

9. This line of reasoning has obvious implications for your chances of achieving the £M_3 targets at acceptable cost. We may suspect that the continuation of a high MLR in recent months has recently <u>added</u>, on balance, to Bank lending to industry and money supply growth. More important, to continue with a high MLR - let alone increase it, would make the £M_3 path

worse still than might otherwise be expected, and this would render the policy of monetary control incredible before very long. The abnormal behaviour of the economy in extreme conditions puts us in a vicious circle as long as we cling to orthodoxy. Moreover an early move towards a more automatic interest-rate generating mechanism (which I strongly favour) would not help matters either, unless the trend level of interest rates has fallen substantially by the time it takes place.

10. It may, of course, be the case that it is impossible by any means now available to get back to within an acceptable distance of the MTFS limits for £M_3. However, as I have argued to you and others before, we should not underestimate a second influence which could come to our aid before long if interest rates fell, in the form of a revival of the capital and debenture markets. The argument is in danger of becoming old hat, but familiarity should not be allowed to breed contempt. In 1975 industrial and commercial companies raised about £1¼ bn (over a third of their cash requirement) from the market and borrowed merely £500 m from the banks. The calculation at the foot of Table 1, which analyses the pattern of company borrowing since 1963, suggests that a repetition of the 1975 pattern could mean that the markets providing companies with some £2½ bn of their cash requirements in 1981. If that was a total substitute for bank lending, the initial effect would be to reduce £M_3 by some 3½%. This kind of recourse to the capital market cannot be counted on, as para 12 of Annex A of the Guy Fawkes papers points out. But that is no ground for ruling the possibility out of court. Some such revival has occurred regularly, if not spectacularly, in each recession, most notably in 1966 and 1971 as well as 1975.

11. The phenomenon of switching borrowing partly away from the Banks to the capital markets is not captured explicitly by the forecasting relationships in the model. While it may be in some measure implicitly, I remain to be convinced that it does so adequately. That is one more ground for a certain scepticism about the conclusions suggested by this part of the model.

The Exchange Rate and the MTFS

12. If one is looking for reasons why the corporate sector should find themselves so wedged-in that they cannot cut their borrowing in response to interest rates, the extreme and unanticipated pressure of the high exchange rate is obviously a major part of the story - not only through its direct influence on the trading sector but, equally important, through the trading sector's impact on domestic suppliers. But there are other aspects to the high real exchange rate which are more worrying. This is well illustrated by the rule of thumb in Douglas Wass's para 7, which suggests that a 10% appreciation of the real exchange rate (and we are currently at 78 on the index of real competitiveness, about 10% above the 71 which was embodied in the MTA projection earlier in the year) takes about £6 bn away from trading companies' income, gives £4 bn to persons and about £2 bn to other companies.

13. The first striking point is that this £4 bn is roughly equivalent to the fiscal adjustment in the terminal year of the MTFS. I read the position as being that, even if output and the PSBR were to proceed henceforward exactly as projected in the MTFS, then there would be no scope in 1983/4 for the adjustment to be given away in tax cuts to persons (or anyone else for that matter). As individuals we are now enjoying the MTFS adjustment through the route of favourable terms of trade and lower inflation.

14. Unfortunately it is not likely that the MTFS output path can be achieved if the real rate remains at anything like the present level. It is not clear by how much GDP would fall short, and hence there would be a further shortfall of revenue addition to the £4 bn in persons' hands which has already been referred to. Para 12 of Annex B suggests a 10% depreciation would add to GDP by 1-2% after two years. On that basis I should imagine, ceteris paribus, that a 10% appreciation in real terms sustained above the real exchange rate assumed in the MTFS would knock 2-3% off GDP after 3-4 years. That would depress receipts of revenue still further, quite apart from implying higher levels of social security and other expenditure.

15. But, as para 12 of Annex B rightly observes, the estimate just quoted of the effect of a 10% depreciation takes no account of the special features of our present predicament.

"To the extent that poor profitability is likely to lead companies to lay off workers to an unusual extent, the easing brought about by a depreciation may have a somewhat larger and quicker effect on unemployment that we would normally expect. Perhaps more important a lower exchange rate would reduce the risk of large scale industrial collapse in a way which cannot easily be quantified."

What the Annex says, correctly, about unemployment rests, of course, on a comparable deeper judgement about the response of output to competitiveness. It must be doubted whether the equations used in the model are appropriate to present conditions of an extreme loss of competitiveness for which, as Mr Burns pointed out, we can find no parallel in economic history. For the bulk of internationally trading firms in normal circumstances in the past, a modest change in competitiveness of, say, 5% in relation to what they were used to led to a relatively marginal decision to sell more or less of their products. However a 10% deterioration in circumstances in which the bulk of firms are already making negligible profits provokes a much more dramatic choice between continuing at an even larger loss or abandoning a whole product line, or even liquidating. In such circumstances (well illustrated by BL and by what we know might happen if it had to close), one is then confronted by a variety of domino effects. Such reasoning suggests that the output response to a 10% change in the real exchange rate might well be much larger than the 1-2% over two years suggested by the model.

16. On this basis the fiscal side of the MTFS might be even more seriously at risk than the model-related speculation in para 12 above suggests. The high real exchange rate would thus exact a very high price indeed over the years in exchange for this year's £4 bn bonus on living standards and a lower rate of inflation.

Looking ahead

17. Looking immediately ahead the exchange rate problem reinforces the case for an early cut in interest rates. The two obstacles to so doing are, first, a move MBCwards, already referred to, and the fact that a lower MLR might be frustrated by high money market rates. There may be no way round that obstacle. But one imagines that it could equally well be the case that this obstacle may rise partly or wholly for "artificial" reasons, because of the present reserve asset requirements. If so, that is one more reason for getting rid of them quickly. [I imagine that the model could offer one useful guidance about the effects of so doing.]

18. In the longer term, the problem of the imbalance of resources can be solved by depreciation, the Burns-Middleton tax shift or some combination of the two. It being improbable that the depreciation route could achieve all that is required, one obviously has to look very actively for B-M-type measures. But I have no doubt myself that they must be second-best; above all, because they cannot match the impact of the high real exchange rate at all closely firm by firm, even if there is no problem about finding the resources.

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19. Some, however, would tend to argue against the depreciation route on other grounds, principally the bad consequences for inflation of allowing a fall in the real value of the pound. This is a very misleading argument. If the present real exchange rate continues, the basic problem is the same in both cases, viz how to extract the recent £6 bn bonus from companies and above all persons and get it back into the pockets of the trading sector. The depreciation route uses the deterioration in the terms of trade, feeding through higher import prices and lower real p.d. income. It will only succeed in shifting those resources if persons do not try and offset the addition to prices and threat to their living standards. The B-M route would have to operate by raising taxes, direct or indirect, on persons (and the profitable companies). The conditions for success are very much the same. As p.3 of Annex C makes clear.

"The size of the ex post shift in income distribution from persons to companies depends on how quickly the impact of the tax changes is dissipated through wage and price adjustments. Despite their difficult financial position companies are likely to begin passing some of the tax cuts forward into prices and backwards into wages during the first year. Similarly the effects of higher personal taxes are likely to lead to higher earnings within a year. A rough rule of thumb is that non-North Sea company disposable income improves by about half the size of the package in the first year, and by virtually nothing in succeeding years."

On that assessment a B-M package is of very transient benefit indeed. All of which goes to show that it is desperately important to bring about a radical change in behaviour if any remedy to our present plight is to work. And if one won't work, the other probably won't either.

20. It is all rather reminiscent of the problem of a child who finds the box of chocolates he is to be given for Christmas days in advance and is caught eating them. It is extremely difficult to get him to give them up. There is much less left to give him on the great day, and little pleasurable surprise involved. To make matters worse, the parents are too poor in this case to buy him anything else!

AR

ADAM RIDLEY
13 November 1980

I have not yet circulated this to other recipients

TABLE 1

SHARES (%) OF MAJOR SOURCES OF INDUSTRIAL AND COMMERCIAL COMPANIES' FUNDS 1963-79

	Bank Borrowing	Ordinary Shares	Debentures	Shares & Debentures	Other*
1963-68	47	11	25.5	36.5	16.5
1969-73	58	9	11	20	22
1974-78	48	18	1	19	33
1979 (1st half)	63	4.5	-	4.5	32.5
1973	70	2	1	3	27
1974	71	2	-1	1	28
1975	14 (£482m)	30	6	36 (£1,235m)	50
1976	47	15	1	16	37
1977	55	14	-1	12	33
1978	54 (£4,913m)	16	1	14 (£759m)	32

* Mortgages, "other loans" (?leasing) and intra-company investment across the exchanges. The latter became a massive source of finance between 1974 and '79. Since the ending of exchange controls, however, there has been a net outflow.

SOURCE: ECONOMIC TRENDS SUPPLEMENT 1980 pp 174, 175

NB If total bank borrowing in 1980 by ICCs is now forecast at, circa, £8 bn; if companies could raise 30% from shares and debentures, that would raise about £2½ bn, which (ceteris paribus) would mean a commensurate reduction in £M_3.

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10 DOWNING STREET

From the Private Secretary

13 November 1980

POLICY OPTIONS

There is one point which I forgot to mention in the note of yesterday's meeting which I sent to you earlier today.

The Prime Minister said that she hoped that it would be possible to have some idea of the November banking figures by 20 November, when she would be making her speech in the Debate on the Address. It would be highly desirable to have this, for the possibility of being able to reduce MLR the following week would affect the tone of her speech. Sir Douglas Wass explained the difficulties of speeding up the collection of the figures, but said he would see what could be done, at least to get a flavour of it.

I am sending a copy of this letter to Sir Robert Armstrong.

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

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1) Mr. Ingham 21
2) Mr. Vereker JV 13/11
3) Return to KRK T.L.

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10 DOWNING STREET

From the Private Secretary

13 November 1980

Copied to Master set - Domestic Monetary Policy

Dear John,

As you know, the Prime Minister held a meeting yesterday afternoon with the Chancellor and Sir Douglas Wass to discuss Sir Douglas' paper on policy options for taking the pressure off the corporate sector (your letter of 7 November refers). Sir Robert Armstrong was also present.

The Chancellor said that he had decided that the immediate aim must be to go for option II - i.e. an early, modest reduction in interest rates. He had in mind a reduction in MLR of 2 per cent. To enable this to take place, he would need to be able to demonstrate that the Government was not abandoning the monetary strategy; and he would therefore need to announce in his speech in the Debate on the Address a credible package of measures. His intention was to announce the following: a further extension of granny bonds and probably a restricted indexed gilt, the outcome of the current public expenditure review, the external financing limits for the nationalised industries in 1981/82, an increase in PRT ... to bring in about £1 billion in 1981/82, and the increase in employee national insurance contribution. He would also have to announce the roll forward of the monetary target and the Government's conclusions on the monetary base control Green Paper. All this would be against the background of the Industry Act forecast which would be published at the same time. Final decisions still had to be taken on most of these matters; but he hoped that - even though the conclusion on public expenditure was likely to be disappointing - the various measures taken together would produce a setting in which a 2 per cent MLR reduction would be defensible. Nonetheless, it had to be recognised that it would involve a considerable element of risk: questions would be raised as to whether the Government was doing enough to get the fiscal balance right, and this might mean that the next budget would have to be even more restrictive; alternatively, it might conceivably be necessary to put MLR up again.

As regards the other options, the Chancellor said that he had concluded that option I - i.e. inflow controls - should not be adopted alongside a reduction in MLR. The two together would give the impression that the Government was moving to an exchange rate objective. But if it turned out towards the end of the month that an MLR reduction was not possible, it would probably be necessary to announce a package of inflow controls to show that the Government was "doing something", even though he did not think that they would have any significant effect. He had rejected the other options in

/Sir Douglas' paper

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Mr Douglas' paper, Option V - i.e. a significant tax switch to the benefit of companies - might be desirable in principle, but it was not possible in terms of cost. Nonetheless, it would be right to lean in the direction of making tax concessions for companies in the next budget.

In discussion the following points were made:-

(i) The proposed 2 per cent reduction in MLR, though desirable on industrial grounds, could very well have a perverse effect on the exchange rate - since it might well result in heavy foreign inflows into gilts. On the other hand, it was argued that a fall in MLR was already being discounted, and that the exchange rate would be just as strong if there was no early reduction. The Prime Minister suggested that, if a 2% reduction were likely to have a perverse effect on the exchange rate, a 2½% reduction might be considered; against this, it was argued that such a figure would look like fine tuning, and would not be understood.

(ii) The public expenditure figures for 1981/82 which the Chancellor would announce following the current review were likely to be £1b or more higher than the figures in the latest public expenditure White Paper; it was therefore crucial for the credibility of the strategy that the Chancellor should announce some of his intentions on tax for 1981/82 at the same time.

(iii) The Prime Minister said she hoped that, even if option I were not adopted, the Treasury would consider switching Bank "customers'" transactions off market again.

(iv) It had been suggested in some quarters that several £b of additional revenue could be raised from PRT rather than the £1b proposed by the Chancellor. But the marginal rate of tax on North Sea fields was already over 90%, and to take out more than an extra £1b could well put at risk the further development of the North Sea. As it was, the reaction of the oil companies was likely to be fairly hostile.

(v) The Prime Minister said she found it difficult to understand the administrative arguments against a fairly radical extension of "Granny Bonds". She hoped that Treasury Ministers would look at the problem, if there was one, imaginatively.

(vi) The Prime Minister said the most disappointing feature of the current PESC review was the deteriorating financial position of the nationalised industries. They had undermined the Government's whole public expenditure strategy. The Chancellor, who reported on a discussion he had had with Sir William Barlow, said that the

/ Government's

Government's experience with the nationalised industries over the last 18 months reinforced the arguments for denationalisation and removing the nationalised industries' monopoly position wherever possible.

In conclusion, the Prime Minister said she was content for the Chancellor to proceed on the basis he had outlined.

I am sending a copy of this letter to Sir Robert Armstrong.

Yours ever,

Tim Lankester

A.J. Wiggins, Esq.,
HM Treasury.

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MR. INGHAM

cc. Mr. Lankester
~~Mr. Wolfson~~

13/4

FORTHCOMING ECONOMIC ANNOUNCEMENTS

I had a session with Professor Burns this morning, at his request, to run over the ground generally and to have a first look at the forthcoming economic announcements. Mrs. Gilmore was present. We agreed that you and I should have a separate meeting with him on either Friday, 21 November, or Monday morning, 24 November, to ensure we are fully au fait with the details. If you agree, I think we should try and make it Friday: Monday is getting a bit late.

2. As you know, the broad shape of the announcement is now taking shape. Because the unemployment figures are to be announced on the 25th, and will again be bad, the Opposition are likely to choose that day for the economic day of the Debate on the Address. So the likely day for the announcement is Tuesday, 25 November. The announcement will cover:

(i) Public expenditure decisions
(ii) Fiscal changes: PPT and employees NIS
(iii) Monetary issues: MBC and rollover
(iv) EFLs.

The Industry Act forecast may well be published on the same day.

3. There are three presentational difficulties in this timing:

(i) I understand that the Prime Minister may well be saying something about the economic strategy on the opening day of the debate, 20 November: what will she be able to say?

(ii) We shall not by 25 November have a very good idea of the November banking figures.

(iii) Speculation about MLR. You will want to see Mr. Lankester's record of the Prime Minister's meeting on 13 November, attached (Mr. Lankester has asked me to stress that this is for your and my eyes only).

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4. The substantive presentational difficulty will be to make the whole package look internally consistent, and consistent with the overall strategy. Until the public expenditure discussion in Cabinet is concluded, it is too early to tell how this is all going to come out. But points we shall need to get across include:

(i) A permanent reduction in the rate of inflation was and remains the main objective of the strategy;

(ii) The MTFS final year target remains, although the path towards it may be different;

(iii) Monetary policy will be determined not just by past movements in the money supply, but also by prospects for future movements.

5. We also discussed pay, and prospects for the next pay round. Professor Burns fears that the Government is becoming too obsessed with pay, and he is less alarmed than I am about the prospects for the next pay round; not until 1982/83, he thinks, will private sector liquidity permit another pay explosion.

J.V.

13 November 1980

11 November 1980
Policy Unit Econ Pol

PRIME MINISTER

Bank - up

POLICY OPTIONS

Here are our comments on Sir Douglas Wass' paper, with references, in brackets, to his numbered paragraphs.

1. IMPORTANT TO SEE THE WOOD FOR THE TREES

1.1 The box we are now in is totally predictable as regards public spending and PSBR (see Annex A), less so as regards behaviour of the exchange rate. A "crisis of belief" was inevitable once the going got rough.

1.2 The MTFS has never been a real strategy. It was simply a set of numerical objectives. There was no strategy - or at least no adequate strategy - for actually making it happen, in terms of deceleration of public expenditure, public sector pay, de-indexing of social security, trade union reform. As we said in our paper of 19 June, the strategy rests on three legs - money supply, public spending, trade union bargaining balance. Monetarism alone can't do the trick.

1.3 The apparent constraints are: we can't allow further rises in PSBR and MLR; we can't find further cuts in public spending; increases in direct taxation are not politically possible; we can't let British industry go under. Obviously something has to give.

1.4 The behaviour of the exchange rate compounds the problem. If oil prices and thus the exchange rate are set to increase further over the next 5-10 years, then we may simply escape from the present box in order to find ourselves in another one. This will require further thinking, outside the scope of these papers.

2. COMMENTS ON THE DOUGLAS WASS OPTIONS

2.1 Option (i): Inflow controls etc

2.1.1 Although I favoured examination of controls, I am beginning to suspect they are a waste of time. Should we be spending administrative time and brain power on something which didn't really work in Switzerland, is even less likely to work in Britain, in the face of all the evidence that trying to control market behaviour doesn't work? I would waste no more time on this.

2.2 Option (ii): A modest cut in interest rates

2.2.1 MLR should be related to the <u>prospective</u> inflation rate, not the past rate. The past six-month rate is already down to 9% or, seasonally corrected, about 11%.

2.2.2 The scars of 1976 are still deep in the Treasury. The fear of a runaway fall in sterling seems exaggerated. The position was different then: a massive PSBR, a huge balance of payments deficit, public spending totally out of control, inflation rates just past their highest ever peak.

2.2.3 We should bring down MLR by two points. This is likely to produce a rush to buy gilts. We should not worry about political embarrassment if we have to put MLR up again. If we have to, we have to.

2.3 Option (iii): A large reduction in interest rates

Not worth serious consideration.

2.4 Option (iv): An explicit exchange rate target

It is not possible to have an exchange rate target <u>and</u> a money supply target.

Not worth serious consideration.

2.5 Option (v): A significant tax switch to the benefit of companies

2.5.1 On the face of it, this would "pre-empt taxable capacity" (paragraph 32). But this is a circular argument. We have to lay our hands on every penny we can to hold down PSBR (which helps companies in the end) and also to help companies directly and immediately. The question is - could we raise further revenue other than from the personal sector: eg via PRT or a levy on bank profits?

5.2 It is argued that if we switch benefit to companies, "wage pressures would be strengthened and employer resistance diminished" (paragraph 31). We are all in danger of getting confused here. Anything we do to help industry is going to have that effect. Of course, wage pressures will be stronger in a buoyant and prosperous corporate sector than in a bankrupt one (so will wages, eventually). We are close to arguing that only adverse conditions really suit employers! What has really happened is that, having failed to significantly reduce trade union power, we are driven to bombing both sides of industry with recession, thus giving the employers the courage of desperation and the unions the fear of unemployment (meanwhile ourselves funking the hard decisions on nationalised lame ducks). We don't seriously believe that an upturn should be discouraged because industrial civil war might break out again?

2.5.3 A tax switch is of course likely to help companies that do not need it, like the banks and the oil companies. Hence the need to do more, rather than less, on PRT and bank profits. Are there other ways to channel help more directly to the companies that need it, rather than those who don't? The rationale for action on bank profits and oil revenues is that the structural adjustment of the economy to North Sea oil is being forced, by external events, at a much faster pace than anyone had predicted, and faster than the corporate sector can readily absorb (a point which Douglas Hague has recently been stressing to us). We are therefore in an unprecedented situation in which those parts of the economy which do not have to make this massive oil-driven restructuring (ie the public sector, the oil companies themselves and the financial sector) must contribute to ease the pain of adjustment. We should be actively communicating this in the context of the Budget, PEWP, cash limits, and EFLs, our pay implications for the public services. It is rough justice, but we are not living in normal times.

2.5.4 Sir Douglas makes an important point (paragraph 34) that even though the switch would be neutral as regards the PSBR, it might actually ease pressure on money supply, because the personal sector tends to borrow less than the corporate, when its disposable income falls.

2.5.5 Unless we think that complaints from industry are unwarranted, we must prepare to make a substantial fiscal switch, as well as achieving our new enlarged PSBR, for 1981-2.

2.6 Option (vi): Pay freeze

2.6.1 As you will remember, we suggested that a pay freeze should be considered immediately after the Election, in order to get control of the economic crisis before it got control of us. The purpose would have been to speed the reduction of inflation without so much damage to the corporate sector and unemployment. It might have allowed us to break out of all our indexing commitments on social security and various parts of public service pay. But it could only have been done as part of a comprehensive emergency package introduced when our post-Election authority and goodwill was at its highest.

2.6.2 A freeze is positively conducive to lower monetary growth (paragraph 39) and we still believe that the exit from a freeze need not be too difficult if the freeze is well designed and trade union bargaining power reduced.

2.6.3 We feel, however, that the time has passed when a freeze is a serious option. We did in any case discuss this with you in the early summer and we agreed that there was no option but to "take the high road". Perhaps we shouldn't reject the possibility out of hand without some discussion, but we don't think it's a serious starter now.

3. CONCLUSION

3.1 Option (ii), a 2% cut in MLR, should be seriously considered. So also should option (v), a fiscal switch to companies. The switch will have to be bigger than we may realise, if it is to hold down PSBR and help companies. Increases in personal taxation should be explicitly linked to nationalised industry over-runs and any excessive public service pay increases. We should perhaps be thinking much bigger than Geoffrey is on PRT. It has been suggested to me that the whole time profile of PRT should be reversed so that we get the front-end benefit when the utility value of the money in our hands may be higher (ie for breaking out of the box rather than fiscal adjustments in the run-up to an Election). We may think this is impossible, but some businessmen would not, in the context of an economic emergency. (The side effects might even be compatible with depletion policy.) But it might raise the exchange rate.

3.2 Consider also a levy on bank profits to supplement PRT.

3.3 We should continue to push hard for significant de-indexing of social security, despite the political difficulties. This is the only place left to find the big numbers (if £25bn of social security were to rise this month by 11.5% instead of 16.5%, it would save £1¼bn in a full year), though it may be too late to win the argument about why these are not "real cuts". I am quite sure that many of the colleagues still do not distinguish between monetary deceleration and PEWP cuts. Until they do, it is going to be very difficult to win the political argument for such changes outside. De-indexing will probably only be possible, however, as part of a bigger package, with explicit "fair distribution of sacrifice" including perhaps a symbolic surcharge on the upper levels of tax. People will accept almost anything if they are persuaded that it is (a) necessary; (b) fair.

3.4 We must not lose sight of the importance of the Green Paper on trade union immunities. Militancy is low now because of the recession. But the underlying structural realities are almost unchanged and the British disease will manifest itself in familiar form as soon as the upturn starts. We must not lose sight of the total strategy, of which reduction of trade union power is a central part. Without it, the corporate sector cannot rebuild its profits, public services pay cannot be curbed, nationalised industries will continue to put their prices up faster than inflation. The UK economy is simply unmanageable until the underlying structure of trade union power, public spending, and public sector indexing commitments, and nationalised industry/union monopoly power, is changed. That is why Governments fail.

3.5 All our experience since the Election shows that we have constantly underestimated the scale of the problem and the speed at which it is getting worse. As a result, we have constantly aimed behind an accelerating target. Our past efforts on Budgets and public expenditure have been like someone pouring buckets of water on a fire, when the realist would have recognised that it was time to dial 999 for the fire engines. The colleagues have never grasped the reality.

3.6 An "over-kill" Budget and PEWP may look like an admission of failure. But it would be better to accept such embarrassment now than real and irreversible failure later. The Whitehall inclination will be to take the minimum and least contentious measures which might just be adequate, in the hope that the true scale of the problem (and thus the inadequacy of our measures to date) can be prevented from becoming visible to the public. We have consistently advocated, since our dinner with David last January, that a "shock package" is needed and you used exactly the same expression when we were talking at Chequers, shortly before the Conference Speech. We have 18 months' leeway to make up and 1981 Budget/PEWP are our last chance to start doing so.

3.7 Tomorrow's discussion can do no more than set the agenda for the most important decisions the Government has yet had to take. Getting those decisions right will take hours and days of reading, writing, thinking and discussion. All the bits of the problem, and the solution, interact with each other. It is a game of chess in which the next move will decide who wins.

JOHN HOSKYNS

ANNEX A.

2

PRIME MINISTER

THE "LONG CAMPAIGN" PAPER

not attached

I attach the first two short sections of the paper and a list of its contents.

I am particularly concerned about the subject of Section 3, "Stabilise the Economy". The sheer power of the process by which inflation and British-style pay bargaining erodes the industrial base and the self-indexing shambles of the public sector and public spending generally, makes mincemeat of our economic policies. It isn't just a matter of cutting expenditure but of uncoupling it from the index, so that the Government does not have a blank cheque commitment to pay, which is quite outside its control. I have commented on the indexing syndrome (eg Ezra's proposals to the NUM, the NCB's indexed-price contract with the CEGB).

At the same time as indexing all the wrong things, Governments have had a completely closed mind on automatic valorisation, absolute commitment to indexing tax bands; there was the whole farce of funny money budgeting, Government guarantees of public utilities borrowing against the exchange rate risk and so on. We have had 15 years of mental confusion which has all but destroyed the economy.

We will make little progress until we bring the whole thing into a stable state. I gave Keith papers on this in 1977, tried to raise it during the Policy Search Team's work in the first half of 1978, touched on it again in the briefing note (of which I sent you a copy at the time) before Geoffrey Howe's "Fentiman" day in March this year.

I am glad to see that this topic is now high on the agenda, and that CPRS are looking at de-indexing. We may have to grasp some very big nettles indeed in this area. But if we do so, tackling the problem from both ends (cutting the pay-out and raising the pay-in) the big numbers could start to come right surprisingly quickly.

I have sent copies of the attached papers to Peter Thorneycroft and Angus Maude.

JH

JOHN HOSKYNS
14 December 1979

7

SECRET

Qa 05181

To: MR LANKESTER

From: J R IBBS

Policy Options

1. I have read Sir Douglas Wass's paper on Policy Options dated 5th November and have the following comments:

(i) I remain convinced that the way in which industry needs to be helped is by reducing the exchange rate rather than by more general easing at this juncture.

(ii) I would agree with the view that attention should be concentrated on options (i) and (ii).

(iii) Expert opinion seems to have little confidence in the effectiveness of option (i) and this suggests that option (ii) may be the one that should be tried. Personally, I still feel intuitively that there may be more in option (i) than at present appears. However, I cannot substantiate this belief with hard fact and argument. My feeling is undoubtedly influenced by experience of other commodity markets - see, for example, the point below on timing.

But see the article in today's FT by Peter Riddell (within folder) which is pretty sceptical of the effectiveness of either control. T.

(iv) It appears that neither of these options is regarded as likely to have a major effect. In these circumstances the manner in which either is tried and, in particular, the timing is likely to be crucial. For example, a modest cut in interest rates may be more effective if it coincides with some weakening of the exchange rate for other (fortuitous) reasons. As in all market operations confidence must be a key factor. On the influences that affect this I would be more guided by the pragmatic judgement of experienced successful operators than by intellectual analysis which probably has to be over-simplified.

2. I am sending a copy of this minute to Sir Robert Armstrong.

JRI

11 November 1980

SECRET

SECRET

Tsy 6

bc. Hoskyns
Wolfson

PSF 11.11.80

10 November 1980

Econ Pol

Policy Options

The Prime Minister has read the memorandum prepared by Sir Douglas Wass which you enclosed with your letter of 7 November. She would like to discuss the memorandum with the Chancellor and with Sir Douglas, and we are trying to fix up a meeting for the middle of this week. The Prime Minister's preliminary view is that options (iii), (iv), (v) and (vi) are non-starters: in her view, the long-term damage that they would cause would be too great.

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

SECRET

GT.

cc Mr Hoskyns
Mr Wolfson

Strategy File

SECRET

Prime Minister 5 #1

You will want to discuss this important paper on policy options prepared by Douglas Wass with the Chancellor next week. He will fix a time - and if you agree - tell the Chancellor he is welcome to bring Douglas Wass with him.

TL

7/11

Agreed MT

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

Preliminary view - options (iii) (iv) (v) & (vi) are NOT ON. The longer term damage could be too great. MT.

7 November 1980

SECRET AND PERSONAL

T.P. Lankester, Esq.,
No.10, Downing Street,
LONDON. S.W.1.

Dear Tim,

POLICY OPTIONS

The Prime Minister asked Sir Douglas Wass on 20 October to explore ways of mitigating the adverse conditions under which British industry is operating.

.... I now attach a copy of a note Sir Douglas Wass has submitted to the Chancellor in accordance with this remit. The Chancellor will be considering this further over the week-end before discussing it with a small group here; he has not yet reached any view about the options discussed. Meanwhile he has asked that the note should be sent at once to the Prime Minister.

The Chancellor and Sir Douglas Wass have not discussed the options with the Governor; nor has he seen the paper. The Chancellor would like an early opportunity to discuss it privately with the Prime Minister well in advance of her meeting now fixed for 18 November. It will be important to ensure that that meeting is able to concentrate on the "operational" monetary policy issues requiring immediate decision.

This is the important meeting on monetary policy.
TL

Yours

John

A.J. WIGGINS

CHANCELLOR OF THE EXCHEQUER

cc Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie

POLICY OPTIONS

I reported to you at the time the substance of my talk with the Prime Minister on 20 October when you were in Luxembourg and when she had just received from the ICI Chairman the news of the Company's third quarter loss. The Prime Minister expressed a very strong wish that I should explore ways of mitigating the adverse conditions in which British industry is operating, so that good and viable companies like ICI should not be driven to the wall. You yourself endorsed this wish and authorised me to submit some options to you.

2. I have done this in consultation with the Second Permanent Secretaries and a handful of people who have been drawn into the discussion on a strict "need to know" basis. I told the Governor in general terms what I was doing, but did not reveal in any detail what the scope of the study was.

3. It is important to establish at the outset the nature of the problem which we wish to resolve. The strong financial pressure to which business generally is being subjected is one manifestation of the policy which is intended to slow down the rate of inflation. I have never myself believed that the statement of the commitment to a deceleration in monetary growth would, through expectations, lead rapidly and as it were on its own account to a fall in wage settlements. In time expectations could well play an important part but until they do, the pressures on wage bargainers and price fixers has to be through powerful financial and economic forces - in short an inability of the customer (employer) to afford the goods or services in question at the price that would otherwise be offered.

4. It seems to me that the success we have been, and can look forward to, having on the inflation front stems directly from this. To appeal therefore for a relief from these financial pressures is implicitly to appeal against the policy being pursued, or at any rate to appeal

against the speed at which the policy has in practice taken effect. I submit that this basic fact has to be accepted at the outset, for almost all the suggestions that are advanced for relieving financial pressures involve in their very nature a relaxation in the policy for defeating inflation.

5. The prior question that has to be asked therefore is whether present policy is too severe, given the objectives set and the costs which it entails. The answer is by no means self-evidently "Yes". Although the achievement in bringing down the underlying rate of inflation to what currently may be thought to be about 12% is remarkable, there are plenty of signs that it may be very difficult to get much further reduction in the next twelve months; and the prospects beyond that are very uncertain indeed. A relaxation of policy could easily lead to a reversal of the trend we have seen in 1980 and make the medium term outlook distinctly worrying.

6. Nor can it be convincingly argued that business conditions as they have evolved this year are very much worse than we expected when we set the current targets and formulated the MTFS. The output path has not diverted much from the forecast and the company sector's financial deficit is not significantly more serious than we expected it would be, partly because de-stocking has proceeded at a faster pace than we predicted. The trade balance and consumer's expenditure have both been stronger than forecast and have gone a long way to offset other deflationary factors. If things are going much as we expected and if we set the parameters of policy with our eyes open, why should we now change?

7. The case for considering a change rests mainly I think on the fact that, as events this year have unfolded, the exchange rate has appreciated much more than we expected. This has had the initial effect of transferring more income than would have been expected from companies that trade internationally to other companies and to consumers. This transfer is mainly the result of smaller, even negative, margins, and partly the result of lower turn-over. A rough rule of thumb is that, ceteris paribus, a 10% appreciation in the effective rate redistributes in the first year about £6 billion of trading company income, £4 billion to persons and £2 billion to companies. Over time, wages and prices

will adjust and tend to restore the original distribution, although the limited scope at present for even more rapid deceleration of nominal wages may slow down the rate at which this occurs. In any case in the short run a sharp rise in the exchange rate can clearly have a serious effect on the finances of trading companies. However, the speed of the adjustment may be so rapid as to cause damage to the capacity of the manufacturing sector that, unlike the effects of reversible cyclical changes, may not easily be restored.

8. The untoward rise in the exchange rate has of course given us an uncovenanted benefit in the fight against inflation, both because it has made employers still more unwilling to concede large wage claims and because its favourable effect on the rpi has taken off some of the pressure for high nominal wages.

9. Not all of the business sector has suffered from the high exchange rate. The service industries (eg distribution) and those which mainly import and sell on the home market (eg the tobacco companies) are not complaining about sterling; nor should they. This has to be noted, because any general relief to the business sector would give a benefit to those who have not been damaged by the exchange rate.

10. These considerations have led us to explore primarily policy options which if implemented would (or perhaps one should say might) reduce the exchange rate somewhat. But we have also looked at other options which would transfer income generally from consumers to producers, irrespective of the latter's vulnerability to overseas competition. Such options are less satisfactory from that point of view. But they may be more satisfactory in other respects, for instance in relation to the damage they would do to the counter-inflation objective. So we have not ruled them out.

11. It should also be stated that the options are not all mutually exclusive, though some clearly are. For example, a cut in interest rates could be combined with some fiscal switch. But equally some of the options would be inconsistent with possible future policy developments. For example, a large administered reduction in interest rates would clearly not be compatible with an early move towards monetary base control.

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The Options

12. The options we have considered, which in some cases are discussed in greater detail in the supporting Annexes, are:-

(i) Inflow controls and some minor measures intended to reduce the exchange rate;

(ii) a modest cut in interest rates;

(iii) a large reduction in interest rates;

(iv) an explicit exchange rate policy;

(v) a significant tax switch to the benefit of companies;

(vi) a pay freeze.

13. The first four options are listed in descending order of compatibility with the Government's present strategy of gearing down inflation through strict control of the money supply. The last two options are not incompatible - option (vi), for example, would if successful actually reinforce the Government's monetary policy - but they present difficult problems of other kinds. I have ranked the pay freeze last because it is so obviously in conflict with everything Ministers have said about an incomes policy and because of the trouble it stores up for the future.

14. Although each of the first four options would involve a relaxation of monetary policy, the first two could just about be presented as consistent with the objectives which have been publicly defined. Many of us have grave doubts, however, whether such consistency would be substantive, particularly given the present underlying rate of increase in the money supply, and developments in the months following their implementation could well show those doubts to be justified. But at the time of their introduction, at least a brave show could be made of their compatibility with policy. Options (iii) and (iv), however, amount to a significant and unconcealable shift in policy. As such they would present political problems of the most serious kind. The

fact that they are included does not indicate that even a priori we think that they are starters.

Inflow controls and other minor measures to reduce the exchange rate

15. So far as inflow controls are concerned, I do not think I need comment in any detail here. Both you and the Prime Minister have seen recent detailed studies and you share our view that such controls would be unlikely to be effective and would create very tiresome administrative problems. But we cannot exclude the possibility that they might offer some short-term gains, if only presentational. On the other hand I must remind you that in our judgement controls on capital inflows would almost certainly lead to some expansion in the money supply. (The reason for this is that some of the transactions you can block are harmless to the money supply - eg foreign purchases of gilts. Inflows would tend to be diverted to assets which are more harmful to block - eg lending to companies which do affect the money supply. TL

16. For the rest, there are one or two minor measures that could be considered. These include taking purchases of sterling by other central banks (customer purchases) off the market; and taking the opportunity of any fall in interest rates to draw the attention of some European etc sovereign borrowers to the possibility of borrowing sterling in the London market. But there is no guarantee that either would achieve anything worthwhile and, like inflow controls, to the extent that they had any effect as intended they would mean taking risks with the money supply.

A modest cut in interest rates

17. What I have in mind is a reduction of 2% at most in MLR. The value of such a move would be partly in the relief it would bring to businessmen through a fall in their interest charges and partly in the hope that it would eliminate the present interest differential in favour of sterling against the dollar and reduce it against other currencies, check the inflows and exert a moderate downward pull on the exchange rate. The former would certainly follow; the latter might not. Overseas investors might smell the interest rate fall as the first move in a sequence of cuts and might actually step up their purchase of gilts (and sterling). There could then be a perverse reaction. To prevent this it would be necessary to authorise the Bank to intervene strongly to stop this happening. Again this might or

might not be successful. Substantial intervention would of course be likely to inflate the money supply.

18. We have considered - and dismissed - the idea of accompanying a cut in MLR with a deliberate and simultaneous move to sell sterling to edge the rate down. Such a move would quickly become apparent to the market who would interpret it in the only possible way - viz that the authorities wanted the exchange rate down and that the twin measures of an interest cut and intervention had this as their end. The effect on the foreign exchange market might then be very marked. There is an immense amount of mobile capital in London which would be likely to move rapidly if it thought both that we wanted - and were prepared to act - to move the rate down and that we were relaxing our monetary stance. The experience of 1976 shows how quickly and strongly an avalanche of selling can take place if the motives of the authorities come under suspicion. The Americans had a similar experience in 1978. So we do not favour intervention to get the rate down in these circumstances; only intervention to stop it rising.

19. There would be some presentational difficulties with a modest interest rate cut, particularly following the October monetary figures. These could be mitigated if the move were linked to some apparent strengthening of fiscal policy - eg an announcement of the outcome of the public expenditure review (though this does not now look a promising piece of cover), or of the new taxes that have been under discussion, or the outcome of our consideration of monetary base control.

A large reduction in Interest Rates

20. This option consists of a decisive and dramatic reduction in MLR, say of 4%. (A variant consisting of a quickish succession of smaller cuts adding up to the same amount is a possibility, though it would lack the signal element of the single large reduction).

21. Because this is what so much of business is now asking for it would do much to mitigate the criticism now being made of Government policy. It would immediately cut the interest costs of business debt and help both cash flow and net profits. It would be surprising if it

did not bring the exchange rate down, but how far it would do so is an open question. In some circumstances the fall might not be large. But if the market interpreted the change as a substantial departure from previous policies, the effect on the exchange rate could be dramatic, and the fall difficult to control - though we do of course have large foreign exchange reserves and could intervene to some extent to try to smooth the fall.

22. The move would of course involve formidable presentational difficulties - much more serious than those which arise with a small interest rate cut. It could hardly be described as consistent with your medium-term strategy - and this would I think be true even if you had not formulated it in the precise and quantified terms of the MTFS. You would have to relate the move to the plight of the business sector and to say that you were broadly satisfied with progress, and with the outlook, on the inflation front and that you were prepared to take some risks on the money supply.

23. Our assessment is that the risks you would be taking would be very substantial indeed. Annex A discusses the consequences in greater detail. You could hardly formulate a money supply target for the year ahead in terms which were reconcilable with the MTFS and if you did you would soon be off course. Many of your stronger supporters would be dismayed and in political terms the move would be seen to be an acceptance of the Opposition's arguments.

<u>An explicit exchange rate target</u>

24. This option would take a number of forms but in its simplest terms it would consist of a statement that henceforth the Bank of England would intervene to hold the exchange rate within some prescribed limits (which might or might not be made public). Interest rate policy would be implemented so as to reinforce this objective and would no longer be determined by reference to the money supply. This is the sort of policy followed briefly (and in money supply terms disastrously) by the Swiss and German authorities when they become alarmed at the drift of the Swiss Franc and the DM respectively.

25. We should need to decide what the exchange rate target should be. The least difficult course might be to freeze it where it is now, in

which case we might consider systematising it by joining the EMS. This step would reassure business that we planned to arrest the erosion of competitiveness through the exchange rate and the fears that the rate would climb even higher would be allayed. But it could well produce consternation among those firms who found the present rate impossible, for the move would largely rule out any relief from their present plight. And further upward pressure on the rate, which we would have to meet by intervention, could not be excluded.

26. A more extreme approach would be to announce a target 10 or 15% below the present rate - rather as was the case when a devaluation took place under the old fixed rate system. But we could not be sure that we could actually enforce such a step-change. If the market judged that we had gone too far, and tried to push the rate up again, we could only hold it down if we were prepared to accept an open ended liability to sell sterling and inflate the money-supply in a unlimited way. On the other hand the market could form the view that the Government had abandoned the present strategy and conclude that sterling was no longer a good risk. The fixed rate would then come under such heavy downward pressure that we might not have the resources to hold it. For my part I think that this would be an unlikely eventuality, though I have to acknowledge that we would be in completely unknown territory and the markets might be very disorderly indeed for a time. The option of entering the EMS would not arise - at least for some time - if our target was much below the present rate, not least because our partners would look critically at the rate we had chosen.

27. From the counter-inflation point of view the move would be severely adverse. Quite apart from the immediate effect on the price level, there would be a substantial risk that the money supply would be inflated even more than with a straightforward and substantial cut in interest rates. It would be quite impossible even to pretend that we were still on a money target policy; at best we would have to say that it was temporarily in suspension and that we would revert to it "when conditions had settled down".

28. Thus whether at the end of the day the company sector would be any better off would be problematical. The initial relief at becoming more competitive might disappear quickly as inflationary expectations

were rekindled.

29. This option is discussed in greater detail in Annex B.

A significant tax switch to the benefit of companies

30. What we have principally in mind here is a reduction in the national insurance surcharge (and possibly also employers' NIC contribution) in addition to the Corporation Tax stock relief measure, both financed by an equivalent increase in taxes on persons (eg an increase in employees' insurance contributions). The reductions could not take effect until next April, but there should be some beneficial expectational effects in the meantime. The order of magnitude of this switch would be for discussion, but the sort of figures we have in mind would be in the region of £3 billion per annum. The move would be an explicit attempt to reverse the distributional effects of the unexpected rise in the exchange rate in recent months and would have to be presented as such.

31. While the immediate effect of the switch would be helpful to companies the effect would be likely to wear off in time. Wage pressures would be strengthened and employer resistance diminished. Indeed it would almost certainly not be long before the trade unions saw the switch as something which they ought explicitly to reverse by putting in inflated wage claims.

32. Another difficulty which the move would present would be that you would have partially preempted the taxable capacity of the personal sector which you will almost certainly have to exploit further in your Budget in March. Following the present public expenditure round it seems likely that you will have to raise personal taxation in relation to what is in the forecast. If you take (say) £3 billion from the personal sector not to reduce the PSBR but to hand over to companies you will be markedly reducing your room for manoeuvre. And you would be thought to be abandoning, or at least postponing, your objectives on personal taxation.

33. Finally the tax switch would give help not only to the hard-pressed business sector but the much less hard-pressed business

sector - ie the banks, the oil companies etc, none of whom have been hard hit by the exchange rate. We have considered whether the tax relief could be slanted particularly to the companies which have been adversely affected by the high exchange rate; but such discrimination would be administratively very difficult and would almost certainly conflict with our European obligations. We think that the benefits would have to be given to all employers alike.

34. One very big advantage in the switch would be that, on the footing that it would be neutral with respect to the PSBR, it would not damage our money supply objectives. There would be no problem of presenting the measure as in conflict with the overall monetary strategy. Indeed it might actually help to ease the pressure on the money supply to the extent that it led to reduced bank borrowing, because the personal sector tends to borrow less when its disposable income falls. The company sector, already borrowing heavily, is unlikely to borrow more.

35. A fuller discussion of this option is set out in Annex C.

Pay freeze

36. This option consists of the immediate announcement of a freeze for twelve months on all employment incomes in both the public and the private sector. Its purpose would not however be primarily that of freezes in the past, viz to check runaway inflation, but to secure a redistribution of income from the consuming to the producing sector.

37. It would in fact be seeking to do by administrative means - but to a larger degree - what the tax switch would be doing by fiscal means. To have this effect it would positively not have to be accompanied by a price freeze, though increases in public sector prices could perhaps be moderated somewhat as a result of the check in the rise of wage costs. Whether the freeze was statutory or not would be an important but not perhaps a decisive question. Of much greater importance would be the chances of compliance. The Trade Unions would probably not take much notice of statutory penalties unless they applied to union funds and even then ways could be found round a liability which would arise if strike action were resorted to. The freeze would only work if the public generally thought that it was a sensible step.

38. On this there would be some puzzlement. However it was presented, it would look like an old-fashioned freeze and people would ask why we were introducing it when wage pressures were actually falling. It would too look like an incomes policy no matter what was said about its purpose or about the freedom of wage bargainers at the end of the freeze.

39. The one advantage of a freeze, if it could be made to stick, apart from the distributional advantage, is that it would not conflict with the Government's monetary objectives. Indeed it would be likely to lead to a lower growth in money supply and/or to lower interest rates, and it would produce lower inflation. Further analysis is set out in Annex D.

Conclusions

40. The common feature of the options discussed above is an attempt to accelerate the contraction of real personal incomes that is already beginning to take place and to transfer income from persons to the manufacturing and trading sector. This is bound to add to existing tensions and could put the personal sector under intolerable strain. This is something you will want yourself to judge. But the need for this shift arises, of course, from the fact that we start from an existing position of disequilibrium between the two sectors.

41. I refrain, however, in this note from making any recommendations, for the subject is fraught with political overtones. In a matter of this sort the decision turns as much on these factors as on the one of deciding on economic priorities.

DW

DOUGLAS WASS
5 November 1980

SECRET

ANNEX A

4% CUT IN MLR

Modalities

The alternatives are a cut of 4% in one go, or a series of smaller steps between now and say Christmas. A large change might do more to put heart into industry: but it would also look more like a sudden failure of nerve. If we could be confident of low money supply figures between now and Christmas, smaller step changes might be easier presentationally - but of course this cannot be guaranteed. The short term prospects for debt sales would be rather better with a slide than a step change.

2. We would expect other 3month rates including banks base rates to fall by about the same amount. Mortgage rates would typically come down more slowly; the prospect of a rise next April (reflected in the NIF) would be averted. The effect on long rates is uncertain, but almost certainly very much smaller - we would guess roughly half the effect on short rates, and under current circumstances maybe even less. The need for the Bank to give substantial amounts of assistance to prevent excessive rises in very short term rates would almost certainly remain. The net effect on the amount of assistance needed is uncertain. A fall in non-bank demand for gilts should make it easier for banks to satisfy their demand for reserve assets. On the other hand, to the extent that bank lending increases, or a withdrawal of overseas £ deposits squeezes bank liquidity, the amount of assistance might have to be increased.

Presentation

3. The market already seems to be discounting some fall in MLR. But it would be difficult to reconcile a 4% cut, even in steps, with continued public commitment to the monetary target for 1980/81. The MLR change could be coupled

with an announcement about PPT, and the prospect of a £1 billion cut in the PSBR; we might stress the seasonal pattern of the PSBR in arguing that monetary growth from now on was likely to be very low; and we might have to call in aid the argument, advanced by several commentators, that the distress element in current levels of bank borrowing by ICC's implies that lower interest rates are more likely to reduce bank advances than increase them, at least in the short term. These arguments would carry some weight. But there must be a strong possibility that such a large fall in MLR coming at a time of manifest and continuing failure to meet the £M3 targets would be interpreted as an abandonment certainly of the 1980/81 target, and possibly of the MTFS as well.

4. At the least the change would create considerable uncertainty. It would be essential to make an early statement about the rollover. This would either (i) reaffirm the Government's commitment to essentially the present targets, explaining why this should be credible, or (ii) set out details of a higher target for the coming year which would also effectively allow for a considerable amount of base drift. The exchange rate might be used as a justification for not compensating for the past overrun on the monetary target, and for raising the MTFS range. The new target would start from September or October: the figuring discussed below suggests that a range centring on 12% would be a realistic estimate of what might be achieved. It might be difficult to announce in the same breath a substantive step to MBC, or more market determined interest rates.

Economic Effects

5. It would be surprising if the exchange rate did not fall by several percent. Our normal rules of thumb, based largely on the experience of the last two years, would point to a fall in the region of 5-10%, within about six months of a 4% cut in MLR

(ie. back to an effective of around 71-75). It should be recalled however, that the effective rate, at 80, is now over 5% above the level forecast for 1980 Q3.

6. Naturally, these estimates are extremely uncertain. In favour of a rather large effect is the possibility that a big cut in MLR could cast doubt on the Government's commitment to tight monetary policies in the medium term; failing this, overseas investors in gilt edged securities could feel that no further falls could be expected for the time being and might be tempted to realise their capital gains and move elsewhere: and a 4% cut would put sterling at an interest rate disadvantage (of about 2%) compared with the $ for the first time since the early Spring.

7. On the other hand, even after a 4% fall, three month rates on sterling would still be significantly above those on all other major currencies except the US dollar and the Italian lire: eg. there would still be a 4% differential over the DM, about 8% over the Swiss franc, and over 3% over the yen. A cut in MLR will not reduce pressure on sterling associated with money market shortages. And of course, interest rates are not the only factor underpinning sterling at present. Earlier this summer, the interest rate differential against the dollar virtually disappeared with little perceptible impact on the rate - and at a time when the money supply overshot substantially. The reasons were probably the deteriorating situation in the Middle East, and the weakening of the DM - factors which may carry weight for some months to come.

8. On balance, therefore, we could not count on a very substantial effect on the exchange rate even with a 4% MLR cut, though some reduction in the rate is probable. The wider effects on the rest of the economy are however critically dependent on the exchange rate response. For working purposes, therefore we have assumed an immediate fall in the rate of about 6%, with initially comparable gains on competitiveness. Much of these effects is likely to be temporary in the absence of further interest rate reductions, since in principle, the nominal exchange rate change should fall back once international portfolios have fully adjusted

to the new pattern of rates.

9. The size of the competitiveness gain depends on the effect on domestic price and earnings. Since the mortgage rate has quite a large weight in the RPI, a fall in both interest rates and the exchange rate may even leave retail prices lower - always providing building society rates follow MLR down. There is no comparable offset on consumer or wholesale prices, though to the extent that a smaller rise in the RPI helps to hold earnings down, the general inflationary consequences of a fall in the exchange rate may, at least in the short to medium term, be less if it is brought about by a fall in interest rates than say intervention.

10. Even if they eventually prove to be temporary, the effects on the exchange rate may still last long enough to produce a significant improvement in the position of the non-North Sea Company sector and some increase in manufacturing (and total) output and employment. A lower exchange rate will also raise the £ price of oil and increase the value of North Sea output, including the tax take. Higher taxes and lower interest payments will reduce the PSBR. Lower interest rates will also improve company disposable income very directly - this could amount to something in the region of £1 billion in 1980, for a 4% MLR cut.* All these effects will take time to build up, of course.

11. Turning to the monetary effects, model relationships might suggest a rise in the money supply building up to about 4 or 5% within six months. Over and above this there is the risk that a fall in interest rates well in excess of market expectations will precipitate a more serious pause in funding. On the other hand other special features of the

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* ICC's only (ie. excluding financial companies and North Sea)

present situation suggest the effect on £M3 may be smaller than usual in the first few quarters, though probably not in the longer term. The balance sheet pressures on banks may mean that the monetary consequences of a fall in gilt demand are less than we would normally expect (since a rather high proportion of gilts are likely to be sold to banks to relive their liquidity problems). The short run response of bank lending may be small, if current levels of ICC's NAFA imply a highly interest inelastic demand for advances.

Industrial and Commercial Companies' net acquisition of financial assets (i.e. the corporate deficit!) JL

12. In the longer term, - (ie. a year to eighteen months) we would expect a total response of £M3 to rise, broadly in line with past experience. The only major reason for expecting a smaller response is the hope that a sharp fall in interest rates would revive the debenture market. Perhaps as critical as the size of the fall in long rates is whether companies believe rates are likely to fall further in the foreseeable future. A large MLR cut would help here but clearly a revival of the debenture market cannot be counted on. Other effects work in the direction of increasing £M3. Even if bank lending fails to respond much to interest rates, higher prices (due to a lower exchange rate) may push up the demand for advances. And the effect of an increased demand for bank lending, against the background of extreme liquid asset pressure on the banks, may be an unusually large rise in the money supply. The precise size of the total effect on £M3 will of course depend on the exchange rate. If a fall in MLR did succeed in precipitating a sharp drop in the exchange rate, the effects on the money supply after a year or so would be correspondingly larger.

SECRET

Overseas Interest Rates

	3 month rate now	Differential against £ after 4% MLR cut
US (Euro $ rate) (4/11)	16.1	-3.2
Germany (3/11)	9.2	3.7
France (3/11)	11.4	1.5
Japan (Gensaki) (3/11)	9.5	3.4
Switzerland (3/11)	5.2	7.7
Italy (3/11)	17.8	-4.9
Canada (3/11)	12.3	0.6
UK 4/11 (interbank rate)	16.9	

SECRET

ANNEX B

AN EXPLICIT EXCHANGE RATE POLICY/INTERVENTION

Modalities

The Bank would be given an exchange rate objective and told to spend as much as was necessary to achieve it. The difficulty with this approach is that it represents an open ended commitment which could result in an explosive growth in the money supply. We have very little idea of how much intervention could be needed to achieve a given effect on the exchange rate, or what the monetary consequences of such intervention might be. The abolition of exchange controls has almost certainly sharply reduced the leverage of official intervention. It has also increased the speculative options open to residents - and hence the potential impact on £M3 of net flows across the exchanges. There is moreover no scientific way of establishing what would be the appropriate level of an exchange rate target if we decided to have one.

2. A less drastic approach might be to give the Bank a fixed sum and tell them to use it to get the rate down as far as was consistent with stable markets. But we do not believe this could be relied upon to produce useful results. (Nor could we be sure what the monetary consequences would be.) The main problem is the difficulty of intervening to depress the rate on a falling market without giving the market the impression that the authorities have some particular objective for the exchange rate. Once this happens, it becomes hard to distinguish between this option and the one outlined in para 1: but without aggressive intervention in this sense, the scope for reducing the exchange rate is strictly limited.

3. It has always been the case that the effect of intervention on expectations is crucial. If the market believes the authorities want the rate down - and have the means to achieve

this - very small amounts of intervention may produce a large change in the rate (eg. Spring 1976). But if operators believe official efforts to influence the rate are doomed to failure - either because reserves are limited, or because the implications for the money supply will ultimately cause them to lose their nerve - large sums can have very little impact. Intervention totalled over £7 billion in 1977 - mostly in a series of fairly short bursts (including £1 billion in July alone) - before the rate was finally uncapped in October - only to rise by a modest 2 points in effective terms. Both the Germans and the Swiss have had similar experiences.

4. The scope for covert intervention is limited. It is not non-existent. but the circumstances have to be right. In the first half of this year for example, the Bank undertook nearly £½ billion spot intervention and as much again in the forward market. without arousing widespread expectations that it was systematically trying to hold the rate down. The fact that the Bank was intervening could be deduced from the monthly reserves announcement. The low key response was probably due to a number of factors:

(i) intervention could be justified with reference to official debt repayments;

(ii) market intervention was relative small - most of the intervention was the counterpart to off-market transactions with Bank customers which were not subsequently unwound;

(iii) the externals were consistently, often heavily negative. thanks to the combined effects of exchange control abolition on private sector capital flows, and the current account deficit: in effect, the authorities were accommodating an excess demand for sterling from non-residents which did not therefore add to £M3;

(iv) the exchange rate was rising, so the story that the Bank was only smoothing had some credibility.

4. For the future, the Bank could be told not to divert customer demand onto the market, as they have been doing recently. As long as customers were a significant source of demand for sterling, this would give them some scope for off-market intervention. They might intervene in the market when the rate was rising, but not when it fell. However if the current account continues in surplus, intervention may lead to positive externals, even if the effect of ending exchange controls ensures a continued capital outflow from the UK private sector. More seriously, it is unlikely that the Bank could achieve a sizeable reduction in the rate from present levels (as distinct from checking a further rise) without resorting to aggressive intervention ie. selling on a falling market.

5. Past experience gives us no reason to suppose that the Bank knows how to intervene in a controlled and limited way to produce an orderly fall in the exchange rate at predictable cost to the monetary target (if it did, it would be unique among Central Banks). On the contrary, experience suggests that such operations either backfire or are ineffective, and that the consequences for the money supply cannot be precisely estimated in advance or at the time. Accordingly the most realistic assumption is that effective intervention to reduce the exchange rate would involve sharply modifying and probably abandoning the present commitment to controlling the money supply.

Presentation

6. If a policy of influencing the exchange rate directly were to succeed without unnecessarily compromising the Government's ultimate objectives eg. on inflation, it would be important to provide some public explanation of what was intended and how this related to the existing strategy. There are in principle a spectrum of possibilities between outright and unqualified commitment to money supply targets, at one extreme, and an equally unqualified and open ended commitment to an exchange rate target at the other.

7. Taking the extreme situation first, the MTFS might be explicity abandoned and the money supply targets might be replaced by a target for the exchange rate. It would not be easy to give substance to a convincing exchange rate target in present circumstances. Given US rates of inflation, a commitment to a given $/£ rate would offer little reassurance that inflation would be successfully brought under control in the medium term. A fixed £/DM perhaps in the context of EMS is slightly more promising - though the flexibility of the EMS limits its value as a medium term constraint on inflation. Choosing an appropriate rate would be difficult, especially since we would need to choose a rate which would be sustainable for some time to come. The UK's special position as an oil producer would make this especially hard. More generally, there must be a questionmark over the credibility of an exchange rate target as an effective discipline on domestic economic policies. It is after all less than a decade since the post-war Bretton Woods system finally collapsed.

8. It is sometimes suggested that we could move towards an exchange rate policy without abandoning the commitment to monetary targets completely, or for all time. Several of those who gave evidence to the Select Committee advocated modifying the commitment to the monetary targets in some way explicitly related to the exchange rate. This is the "flexible rule" approach advocated by, for example, Artis, Miller and Buiter. They envisage that the Government would say that the MTFS targets were conditional on the exchange rate remaining within some pre-specified and probably very broad band (say 60-75 effective). The new "rule" is that within this band there is no intervention and instruments are directed exclusively to domestic objectives (as now). But when the rate rises above the band, £M3 targets are temporarily suspended and policy is directed to bring the exchange rate back (much as if we had an explicit exchange rate policy).

9. The justification for this hybrid approach is essentially the source of the current anxiety about the rate: that the exchange rate is a key part of the transmission mechanism, and an unexpected rise in the rate alters the impact of a given monetary stance in an unintended way - altering the scale and distribution of the effect on output as well as the effect on inflation. But there are problems both of principle and practice. As we have pointed out ourselves to the Select Committe complicated rules may not be worth having. They will be less easil understood and so have less effect on expectations. Moreover , in present circumstances, this approach offers no new solution to the immediate problem of getting the exchange rate down. Indeed since the top of the band would almost certainly be below the present market rate it might be sensible to wait until the rate had reached more acceptable levels before announcing the band at all. In the meantime, we would effectively be operating an unmodified exchange rate policy.

Economic Effects

10. It is not possible to say much about the exchange rate and monetary consequences of given amounts of intervention. We can say a bit more about the effects of a change in the exchange rate, assuming one can be successfully engineered. The critical issue is of course how quickly earnings and prices respond and hence how long the gain in competitiveness lasts. Current estimates suggest that a 10% depreciation would increase prices by about 2 or 3% after a year, and perhaps 4% after two. To the extent that the current level of the exchange rate has not yet fed through to the price level, (and is not even reflected in the forecast) this change would largely be forestalling a bonus on the price level which we have not yet fully taken into account.

11. A lower exchange rate will redistribute income from persons to companies. There will also be a substantial redistribution within the company sector, towards industries trading in international markets and away from those relatively sheltered from competition. These changes are, in principle, only temporary; as earnings rise to compensate for the change in the rate, the initial switch from wages to profits will be reversed. The corollary is that the redistributive effects of the recent rise in the rate will be only temporary too - though we have little evidence on the effects of appreciations, and it is at least possible that they are not simply the mirrow image of depreciations.

12. A 10 per cent depreciation might raise GDP by about 1 or 2 per cent after 2 years - trade would benefit but consumer spending would be cut. This figure takes no account of the special features of the outlook for the next year. To the extent that poor profitability is likely to lead companies to lay off workers to an unusual extent, the easing brought about by a depreciation may have a somewhat larger and quicker effect on unemployment than we would normally expect. Perhaps more important a lower exchange rate would reduce the risk of large scale industrial collapse in a way which cannot easily be quantified.

13. The monetary consequences are inevitably very speculative: very broadly a 10 per cent depreciation might add about 5 per cent to £M3 after a year (with a little more to come in the second year). In present circumstances it is worth noting that intervention will have the effect of increasing bank liquidity, thus helping to tak some of the pressure off very short rates (and possibly also the exchange rate) and reducing the amount of regular assistance which the Bank need to give to prevent interest rates rising further.

ANNEX C

Tax switch from persons to companies

Modalities

Employers' NI contributions and/or the surcharge would be reduced from April 1981, and direct taxes on persons increased to the same extent. The intention to do this would be announced in November. The corporation tax stock relief scheme would also be reformed from April 1981, and announced in advance.

Decisions would have to be taken about the scale of the tax switch, and about the following other aspects:

(a) whether the benefits to the company sector (NI contributions and stock relief) should exactly match the costs to the personal sector, and if so whether they should be equated in revenue or PSBR terms;

(b) the balance between the NI surcharge and basic employers' contributions in the company package;

(c) the mix of changes in basic rate, higher rate, allowances and thresholds, and employees' NI contributions.

The stock relief proposals cost about £300 million in 1981-82. They could thus be combined with either a 2½% points reduction in NIS, costing about £1.7 billion, and a £2 billion increase in personal sector taxation (about 2¼% increase in basic rate, or an increase in allowances and thresholds 12% points less than full revalorisation); or abolition of NIS and reduction in other employers' contributions of about £1.3 billion, and a £4 billion increase in personal sector taxation; or any other scale. Where quantitative effects are given below they refer to these small or large packages as specified.

It might be desirable, although it would be administratively difficult (perhaps impossible in the first year or so) to concentrate the reduction in employers' contributions on the manufacturing sector, or perhaps on a slightly wider grouping designed to include some of the non-manufacturing traded goods (and services) sectors. If it was concentrated on manufacturing a £2 billion switch might permit the abolition of NIS for manufacturing firms, and the reduction of their other employers' contributions by about £1 billion.

Presentation

The medium term financial strategy does not contain any commitment to a particular structure of taxes, and so the tax switch is broadly consistent with it. However, it conflicts with the objective of reducing the burden of personal taxation. This could be justified as being a temporary expedient, necessitated by the unplanned and unexpectedly, big squeeze on trading companies caused by the exchange rate. There would therefore be an implicit commitment to reverse the situation within a few years. However, the tax switch would improve interest rates, another objective.

Economic effects

The main impact of the tax switch is on the sectoral distribution of income in the short run and interest rates. Aggregate output and prices are not much affected, although, to the extent that they are, the effects are beneficial.

Output may rise slightly (perhaps by as much as ½% with the large package), because the beneficial competitiveness and domestic supply effects from reducing the payroll tax probably outweigh the reduction in demand from lower real personal incomes. The improvement in output will disappear over time.

The RPI may be marginally lower, but probably not by more than ½% even with the large package. The downward pressure from lower costs and interest rates is offset by upward pressure from wages which respond to increased personal taxation and lower employment costs. With unchanged money supply any change in the RPI will also disappear over time.

The size of the ex post shift in income distribution from persons to companies depends on how quickly the impact of the tax changes is dissipated through wage and price adjustments. Despite their difficult financial position companies are likely to begin passing some of the tax cuts forwards into prices and backwards into wages during the first year. Similarly the effects of higher personal taxes are likely to lead to higher earnings within a year. A rough rule of thumb is that non-North Sea company disposable income improves by about half the size of the package in the first year, and by virtually nothing in succeeding years. Company net acquisition of financial assets might improve by less, mainly because of a recovery of stockbuilding, and personal sector income might deteriorate by about the same amount. Thus the large package might improve company income by about £2 billion in 1981-82, and the small package by £1 billion.

Interest rates might be expected to ease, despite little or no change in the PSBR. This would follow from a reduction in bank borrowing. The personal sector tends to borrow less when disposable income falls, while the company sector would not be expected to borrow more given the existing high level of borrowing. A lower level of bank borrowing would reduce the pressure on banks' balance sheets, and hence their need to bid for funds in the short-term money markets. The large package might produce falls in short rates of 2-2½ percentage points in the first year or two (beginning with the announcement of the measures rather than their implementation), and the small package falls of 1-1½ percentage points.

Little significant change in the exchange rate should be expected. There will be downward pressure from lower interest rates and upward pressure from possibly higher output. On balance the rate might be lower, perhaps by $\frac{1}{2}$-1% with the large package. Labour cost competitiveness will, of course, be significantly better, by 3-4% with the large package in the first year (but much less thereafter), because of the reduction in employers' contributions.

If the reduction in employers' contributions were concentrated on manufacturing the improvement in output might be somewhat more marked, because of the non-linear effects of better competitiveness and company disposable income when profits are subject to a severe squeeze. The distribution of disposable income within the company sector would also be different, of course, and this could lead to a greater fall in interest rates than if the employers' contributions were spread evenly.

ANNEX D

WAGE FREEZE

Modalities

The wage freeze would be imposed with immediate effect, and would last a whole year. There would be no controls over prices or dividends. Many decisions would have to be taken about the details, and about what guidances or institutional arrangements should succeed it. The main issues include:

(a) where exactly should the line for the beginning of the freeze be drawn (eg should groups with agreed settlements, but with a delay in implementation, be allowed to go ahead)?

(b) what, if anything, should be done about normal annual increments?

(c) can anything be done to prevent some wage drift, associated with regrading jobs, productivity agreements, payment-by-results, cheating, etc?

(d) should an announcement be made at the beginning about the institutional arrangements (defined broadly to include free collective bargaining) which the Government hope will succeed the freeze?

(e) if so, what should it say?

Presentation

A wage freeze can easily be presented as being consistent with the medium term financial strategy. Its purpose is to redistribute income from persons to companies in the short term to help compensat for the high exchange rate, speed up the reduction in inflation that will anyway occur, and reduce the transitional loss of output and employment. It is more difficult to meet criticism that it represents the abandonment of the commitment to liberate markets. The justification would have to be twofold.

First, market forces have been slow to adjust to the new liberal regime. The adjustment mechanisms of the labour market in particular, after decades of intervention and protection from some of the harsher realities, are very rusty and are operating only rather slowly. In time they will gain in efficiency, but that might be too long to avoid considerable further loss of output and employment. The wage freeze provides a short cut, without significantly damaging long term market forces. [This line would have to be accompanied by a commitment to re-establish the market at the end of the freeze.]

Secondly, the transitional loss of output and employment associated with reducing inflation has been augmented by the unplanned and unexplained part of the rise in the exchange rate. There is therefore a greater strain on the traded goods sector than was intended, and policy must be adjusted to alleviate it. A wage freeze without price controls will initially bring about a large transfer of income from persons to companies. This will be partly reversed after the end of the freeze, but by then the beneficial competitiveness, real wealth and interest rate effects will be having a substantial effect on output and profits.

As a defensive point, the substantial loss of real wages implied by the freeze (at the end of 1981 5-8% below the forecast level which itself is lower than at the end of 1980) might be presented as the price to be paid for higher output and employment from 1982 onwards.

Economic effects

The medium term effects depend crucially on what happens to nominal wages at the end of the freeze. There will presumably be some bounceback, so that real wages move up to and perhaps beyond the level they would have been at (beyond if workers manage to restore the cumulative loss of real income during the freeze). While real wages are unlikely to remain at the level they reach at the end of the freeze, nor would one expect them to overshoot so as to restore the full cumulative loss within the first year or so.

There is a temporary fall in output because of the reduction in personal disposable income. It will probably not last very long (a year or so) and might not exceed ½%. After that higher output than would otherwise occur might be expected, stimulated by:

(a) the improvement in competitiveness;

(b) lower interest rates;

(c) higher real wealth, and

(d) possibly higher real personal disposable incomes (depending on the degree of bounceback of nominal earnings).

In two or three years' time, the stock of unemployment might be lower than without the wage freeze.

The speed at which prices come down depends on how quickly companies choose to pass on the reduction in their costs. This might be slower than in more normal times, because they could take the opportunity to improve their profits and cash flow, but it might be faster because the sheer size of the fall in costs (relative to forecast) means that they only have to hold back a small part. By the end of 1981 the fall in prices might be about half of the fall in costs (both relative to base). Beyond 1981 the rise in prices will depend on what sort of wages bounce-back occurs. The rate of inflation is likely to be higher for a few years than it would have been. It could therefore rise from, say, 5-8% for the year to 1981 Q4 to 10-15% for the year to 1982 Q4. However it would probably not be so high as to raise the price level above the base. Indeed, if the cumulative loss of real wages is not fully restored, the price level might remain lower than in the base for a number of years although eventually it will tend to the same level, with given monetary growth.

The transfer of income to companies in 1981 could be large, perhaps as much as £2½-3½ billion. Much of this would disappear in 1982 and beyond, although the higher level of output and competitiveness would produce a continuing net improvement in company finances for a number of years. By contrast real wages would fall, by perhaps 5-8% at the maximum at the end of 1981. The level of real wages could be expected to recover quickly, and perhaps overshoot temporarily.

The reduction in the price level and the improvement in the company financial position will put downward pressure on interest rates, for given monetary growth. Assuming that financial markets anticipate the bounceback of nominal earnings after the freeze, short term interest rates might fall by 1-2% points in the first year or so. After that the fall in the PSBR resulting from higher output, lower prices and lower debt interest payments puts added downward pressure on interest rates, so that the fall (relative to base) after 3-4 years may be larger still.

Competitiveness improves considerably in the first year or two, mainly because of the lower earnings and prices rather than because of a lower nominal exchange rate. The exchange rate is subject to conflicting pressures: in a downward direction from capital account and, after the first year or so, the pressure of demand, and in an upward direction from the effects of lower prices and costs on the current account. The resulting movement may not be large.

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PRIME MINISTER

I have seen a copy of the Chancellor of the Exchequer's note of 4 November about the timetable for announcing decisions on public expenditure and other matters.

2. The Chancellor will probably be reluctant to contemplate anything that could be described as an Autumn Budget. But the case for a comprehensive announcement of decisions, not just the cash limits and the Rate Support Grant (which have to be announced in November anyway) but also on public expenditure reductions and on tax proposals, seems to me to become increasingly strong.

3. It is widely believed outside that the Cabinet is looking for reductions in public expenditure of the order of £2,000 million. What is actually achieved is likely to become as widely known as the objective. The further achievement falls short of the objective, the greater the damage to the credibility of the Government's strategy, the greater the fear of a very high PSBR next year, the more damage will be done to prospects and hopes of a fall in interest rates and of the exchange rate. Indeed, expectations could force both interest rates and the exchange rate still further up.

4. These effects could be much reduced, credibility maintained, and the prospect of reduced interest rates held out, if the Chancellor could demonstrate that by a combination of agreed cuts in public expenditure and specific changes in taxation he would be able to keep the PSBR next year down to the sort of level he has in mind (which seems to be somewhere about £9 to £9½ billion). That would also provide a framework for whatever monetary decisions - either on rates or on techniques - he wanted to announce.

5. You will remember that in 1968 Roy Jenkins announced public expenditure cuts in January but postponed his tax announcements until Budget time. He came to regret the postponement, because the expenditure decisions were not credible without the tax decisions, and there was a very difficult three month period between the two.

6. There is in any case something to be said, in terms of impact upon industry and markets, for getting all the agony out and over in one fell swoop, rather than paying it out in instalments. People then stop expecting more agony, and begin to look forward to the possibility of better things: and industry may then be more disposed to hold on to markets and accept lack of profitability for a little longer, because they see the prospect of improvement more clearly.

ROBERT ARMSTRONG

ROBERT ARMSTRONG

5 November 1980

SECRET

Mr Wright (C.O.).

Prime Minister
You can discuss this with the Chancellor on Thursday morning.
TL 4.11.80

3

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

Original on:—
Public Exp: Econ Pol: Pt 11

PRIME MINISTER

I have been considering the timetable for announcing the decisions we shall be taking in the coming weeks and I thought that you might find it helpful to see the attached schedule which summarises what I have in mind. For convenience the schedule also notes the dates of announcement of important economic statistics and other major relevant developments.

2. As you will see, I envisage essentially a two-stage operation. The first stage is the announcement of the cash limits pay and price factors soon after we have decided them next week. I think it is very important to announce these before the CBI conference on 10 and 11 November, and I envisage a written Parliamentary Question, preferably on Thursday 6 November, but failing that on Friday 7 November so as to achieve maximum impact through the weekend press.

We need the RSG assumptions announced on Thursday to influence the firemen's pay negotiations which have been suspended until Friday.
TL

3. The second stage is the announcement of our monetary decisions (which will include the roll-over and any decisions we may by then have taken on monetary base control) together with the Industry Act forecast, which we are required by law to publish by the end of the month, and our decisions on nationalised industries EFLs. There is also the question of any tax decisions that we may take now - principally the possibility of changes on PRT and employees' national insurance contributions. Since I should want to reflect these in the Industry Act forecast, publication of the latter could not precede their announcement. And in any case early announcement would be operationally necessary if any such changes were to take effect from next April.

SECRET

4. What I have in mind is announcement of the monetary decisions in the course of my speech on the economic day of the Debate on the Address. Choice of date will, of course, be a matter for the Opposition. But in the past they have generally chosen the final or penultimate day (i.e. 26 or 27 November) and, with the October unemployment figures being published on 25 November, I would expect them to choose the earlier of the two days. As indicated above, if we had also taken decisions on either of the two major tax possibilities, I would include an announcement in the same speech.

5. I envisage that we should also publish on the same day the Industry Act forecast and our decisions on the EFLs. The former will, of course, reflect the various other decisions announced and will contain among other things our latest estimate of the PSBR for the current year together with at least an indication of our forecast for 1981-82. I am giving further separate consideration to the problems of presentation here. So far as the EFLs are concerned (which we could announce by Written PQ) it will be a pity not to be able to publish them before the NUM delegates conference scheduled for 14 November. But I believe that publication before then of the public service cash limits pay and price factors will do as much, if not more, to set the general tone in the public sector.

6. One item for which no date is given in my schedule is the possible announcement about our intentions on public expenditure generally, with at least such information about particular decisions or programmes as is necessary to make the target credible. There is no doubt that we shall have to say something. Given the intense interest and speculation, we shall not be able to avoid this. And in any case we shall need to demonstrate how the EFLs, which will be manifestly larger than those in the last White Paper, are consistent with

continued adherence to our public expenditure strategy as a whole.

7. I have not yet decided how best this should be tackled. There are some arguments for an announcement before the end of the session (i.e. before 14 November) if we have reached the main decisions by then. If we delay, there will be continued press speculation and the risk of leaks. But on the other hand we may not be ready then to announce any possible decisions on social security. And there is also a case for postponing such an announcement until the statement during the economic debate referred to above, so that we can relate our public expenditure posture to our monetary and fiscal plans as a whole.

Probably best to keep public expenditure decisions for announcement at the same time as everything else.

R.

8. I should welcome an opportunity to have an early word with you about these possibilities.

(G.H.)

4 November 1980

Timetable for Announcement of Policy Decisions

Date	Publication of economic statistics or other relevant developments	Policy Announcement	Comment
November			
4	October banking figures, including provisional money supply		
5			
6	[Possible written PQ on stock relief]		[Trailer for consultative document on 14 November]
7		Written PQ on cash limits pay and price factors.	Assumes Cabinet decide on 4 Nov or 6 Nov at latest. Timed to catch weekend press in advance of CBI conference
10) 11)	CBI Conference.	Local Authority Consultative Council informed provisionally of RSG settlement.	Would include cash limit factors but not necessarily decision on volume change. (Formal communication likely to be on 4 December, precede by warning of any change in volume).
12			
13	October money supply figures		
14	October RPI Parliament Prorogued.		
17			
18			
19			
20	Queen's speech. PSBR figure for first half 1980-81.		
21			
	CBI Industry Trends Survey (November).		

25	Unemployment figures (November)		
26	[Proofs of Winter Supplementary Estimates to Select Committees.]	Possible complex of announcements as follows: (a) In speech in economic debate: (i) £M3 roll-over (ii) any decisions on MBC (iii) any tax decisions for 1981-82 (b) Industry Act Forecast up to end 1981 (by press notice or Supplement to Treasury Economic Progress Report). (c) Nationalised Industries EFLs (by written PQ).	Assumes Opposition will choose this day for economic debate. For consideration whether speech should also be vehicle for public expenditure announcement.

COPY NO. 1

ECONOMIC PROSPECTS: OCTOBER 1980 REPORT

I attach the main report. It is for your personal use only and must not be communicated to others without permission from me.

H P EVANS
EA
31 October 1980

H M Treasury
Whitehall
SW1

He shd just have said "No" to D. Healey.
And he shd have mentioned N Sea oil as pushing up £.
[I shd be disinclined to say we cd not do X if we reduced int. rates, in case we actually did this.]

Why didn't he just say that with 4% lower interest rates we wouldn't be able to fund the PSBR?

SHORT TERM ECONOMIC PROSPECTS : OCTOBER 1980 REPORT

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Charts attached to this report

1. UK output and world output
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F Prices
G Wages
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I Output and productivity
J Factor incomes

SHORT TERM ECONOMIC PROSPECTS : OCTOBER 1980 REPORT

Introduction and summary

1980 is turning out to be a year of falling activity and inflation, as generally forecast. But the reasons for these developments were not well anticipated and the next section of the report tries to assess recent events in the light of the latest information.

2. The projections cover the period from 1980 to early 1985, but this report concentrates on the first two years. It is assumed that present or planned policies are implemented. The background for this forecast of the UK is a world economy likely to expand only 1% this year and 2% next year, and in which inflationary pressures in the main OECD countries moderate only slowly. We have taken no account at all of any implications of the Iraq-Iran war.

3. The main focus of the forecast is on three issues : the consistency of monetary and fiscal policy and movements in the PSBR; the rate of inflation; and the extent and length of the recession.

4. The message of the forecast can be summarised as follows:

(i) On the fiscal policy assumptions specified, interest rates will probably have to stay high if the monetary targets are to be met.

(ii) The rate of inflation moderates, but only slowly.

(iii) Recession in 1980 will extend through 1981, with further large rises in unemployment. Activity may not fall further after 1981.

(iv) With continued high interest rates forecast, the exchange rate may not decline much or even at all : hence competitiveness remain very poor.

5. Table 1 shows a summary of the main points of the central forecast. In order to illustrate the effects of two types of uncertainty, we have looked at alternative forecasts in which:

(i) activity is appreciably higher by 1982, as a result of a better trade performance;

(ii) the exchange rate falls sharply in 1981.

6. Specifying the variants in this way does not mean that we believe the risks are all on one side : on the contrary, all the forecasters would wish to emphasise the uncertainties in these and other areas on both sides of the central forecast. Summaries of these alternative forecasts are also given in table 1, and Appendix 3 gives more details.

7. The forecasters are only too aware of the major uncertainties in the economic prospects over the next few years. Perhaps the central issue is the speed at which employers and employees adjust downwards their inflationary expectations in an environment of tight money and recession. Past experience, in this country and elsewhere, though not providing clear answers, suggests to us that the adjustment is not likely to be rapid enough to avoid continuing recession and substantial, though declining, inflation for some time to come.

8. This report provides a summary of the forecast, with charts and tables showing the main elements of interest. More detailed documentation of the forecast, covering a longer period, with many more tables, will be available later.

<u>The current state of the economy</u>

9. Much of the forecasting exercise has been concerned with assessing and interpreting the very recent behaviour of the economy, not least because the latest statistics, and substantial revisions to earlier ones, display a picture markedly different from that expected by many forecasters earlier in the year.

SUMMARY OF FORECASTS

			Central Forecast	Alternative Forecasts: Better trade	Alternative Forecasts: Lower exchange rate
PSBR £bn	1979-80		10		
	1980-81		10¾		
	1981-82		11¼	10½	11½
	1982-83		9½	7¼	9¼
Interest rate (a)	1979	Q4	15¾		
	1980	"	15¾		
	1981	"	15½	15¼	18½
	1982	"	14½	13¼	16¾
Exchange rate (b)	1979	Q4	68¾		
	1980	"	75½		
	1981	"	74½	75½	67½
	1982	"	71½	72½	64½
Inflation % changes in the RPI	1979	Q4	17¼		
	1980	"	16¼		
	1981	"	13¼	13¼	15¾
	1982	"	11¼	10¾	13
GDP growth % by volume	1979		1¾		
	1980		-2¾		
	1981		-2½	-2	-2¼
	1982		-	1¼	+ ½
Company financial balance, £bn (c)	1979		-3½		
	1980		-2½		
	1981		-2½	- 2	-2
	1982		-1	- 1½	-
Unemployment Rate % (d)	1979	Q4	5¼		
	1980	"	7¾		
	1981	"	10¼	10	10
	1982	"	11½	10¾	11¼

Notes: (a) The interest rate is the 3 month interbank rate.

(b) Exchange rate is the effective rate based on 1971Q4=100.

(c) Company financial balance refers to the financial surplus of Industrial and Commercial companies.

(d) Unemployment is given excluding school-leavers seasonally adjusted as a percent of the labour force.

10. 1980 had been expected for some time to be a year of recession and falling inflation, as a result of poor trade performance caused by exceptionally weak competitiveness, and tight monetary and fiscal policy (with both the real money supply and the real PSBR expected to decline sharply). 1980 is now clearly emerging as a recession year, and the inflation rate is falling; yet the trade balance has improved markedly; and since the first quarter fiscal and monetary policy have not been particularly restrictive, though the stance last year was generally fairly tight. The rest of this section presents an interpretation of recent indicators.

11. The last six months or so look like a cyclical turning point for the UK economy. Before then, output and employment had been well maintained, despite mounting cash flow problems for some companies squeezed by a high exchange rate and rapidly rising domestic costs, especially interest payments, wages and energy costs. Up to early 1980, many companies were spending heavily on fixed investment, stocks and dividends.

12. Around the turn of the year, and still more in the spring, many companies were finding their current financial position much worse than expected, with future prospects distinctly gloomier. The widespread acceleration of domestic costs was continuing; the exchange rate was continuing to rise; export orders (despite buoyant world trade up to the early part of the year) were falling, partly because of poor competitiveness, partly because most other industrialised countries were beginning to experience a fall in domestic demand; and earlier plans for high levels of fixed investment and dividends were still being carried through. The result was a concerted fall in orders in the second quarter of 1980, accompanied by: attempts (only partly successful at first) to get rid of stocks by cutting prices (partly because of the competition from imports of manufactures, the prices of which have fallen 3% in sterling since March); and reductions in output and in employment. These tendencies can be seen clearly in successive replies to the CBI enquiries:

Percentage balances of ups or downs

	Firms working below capacity	Trend in total order book	Trend in output volume over next 4 months	Present volume of stocks too high	Trend in average prices of domestic orders
1979 Q4	61	-28	1	7	60
1980 Q1	63	-38	-11	15	65
Q2	70	-56	-25	26	56
Q3	76	-71	-44	36	33

13. Thus companies, both in the more exposed parts of manufacturing, and in distribution and elsewhere, are now adjusting rapidly to the change in expectations. The third quarter saw a further large fall in employment (and hence a big rise in unemployment) and, probably, further destocking, as profit margins were cut again. Pay settlements, a high level of which was established last year, have not in general responded to the change in the economic climate, but a major reappraisal now seems to be taking place of what can be afforded, above all by employers, but also by employees, in the light of rising bankruptcies, higher unemployment, and the reduction in the rate of inflation.

14. The failure of monetary and fiscal policies in the first half of the current financial year to be anything like as tight as intended meant that demand did not fall as much as it would otherwise have done and that the financial problems of companies were less severe (their needs for finance were less; and they were able to borrow more than if monetary policy had been tighter). Thus monetary growth well in excess of the anticipated rate was helping to sustain activity, at the cost of higher inflation in the future. However, to judge from published forecasts, expectations of inflation have been falling over the summer, probably reflecting the following factors: the strength of the exchange rate, the greater than expected impact of recession on inflation; and the continued belief in the government's intention to adhere to medium term financial targets.

15. Earlier warnings that the steep deterioration in competitiveness would cause the balance of trade in manufactures to worsen this year have not, apparently, been borne out. There are, however, strong

reasons (above all the failure of the UK export volume of manufactures to increase, when world trade up to the beginning of this year was expanding by a probably 10% or more) for believing that poor competitiveness has, of itself, make the trade balance this year a good deal worse than it otherwise would have been; and it has made a major contribution to many companies' financial problems. For many companies the high level of interest rates and other rapidly rising domestic costs have been more important. The weakness of private domestic demand has had a marked impact on imports and so, notwithstanding losses due to competitiveness, the trade balance this year has improved. The knowledge that export orders were falling, and the growing expectation that competitiveness was unlikely to improve much very quickly, was probably a major element in the reappraisal in the spring. Indeed, the weakness of domestic demand, and above all of stockbuilding, may be seen in part as an early response to falling export orders. But it also reflects an inability on the part of retailers to pass on higher costs to the extent usual in previous periods of high inflation.

16. It may be helpful to see recent trends in the economy in terms of the increases in nominal magnitudes, for both expenditure and income, as displayed in table 2, page 18. Some expenditure components, such as retail sales and exports, were no more than 13% up on a year earlier, while public consumption was 25% up. On the income side, employment incomes have continued to rise rapidly while profits in nominal terms were - we think - falling by the third quarter.

<u>World Economic Prospects</u> Chart 1

17. Activity in most industrialised countries fell in the second quarter of this year, with a particularly sharp fall in the US. But there are signs that the US recession may be coming to an end, and overall we see a rise in output in the major seven countries of around 1% this year and a modest improvement next year. A surprising development has been the buoyancy of world trade up to the first quarter of this year, with OPEC stepping up their imports and with manufactures growing particularly fast.

18. Oil prices have weakened recently and we see little change in the real price of oil over the next eighteen months or so. Commodity prices are expected to decline relative to manufactures' prices, in the face of weak demand. Inflation in most industrialised countries has now begun to fall off, though only very limited further reductions seem in prospect for 1981.

19. A full report on the world economic prospects exercise was circulated by Mr Turnbull on 24 September. No account was taken in that exercise, nor in the present forecast of the UK, of any consequences for the world economy of the Iraq-Iran war.

Policy assumptions

20. These economic forecasts are prepared mainly to assist in decisions on monetary and fiscal policy this autumn. In general, the forecasts assume, as the most convenient basis for decision-taking, that existing policies are continued. In some important areas, that concept needs to be clarified or changed.

21. Pay - In the public services, we have made the policy assumption that most groups will obtain earnings increases of 9% as a consequence of settlements in the current pay round. (Though for those local authority employees who settle in the current quarter, we have assumed that settlements will be higher, mostly because of very high awards likely for two special cases). This assumption about public services' pay looks tight in relation to the forecast for the private sector (paragraph 39).

22. Monetary policy - from April 1981, monetary growth is set at the middle of the MTFS range for each year. For the remainder of this financial year, the forecast is constructed on the basis that interest rates remain high with the result that underlying monetary growth comes back to near the top of the target range. The forecast assumed the continuation of existing methods of monetary control. The exchange rate floats freely.

23. Public expenditure - cash limits stick in 1980-81 though EFL's are broken. For the period 1981-84, we assume, except for the demand determined categories of expenditure, maintenance of the volume plans embodied in Cmnd 7841, modified by savings on our EC contribution, by the changes proposed by the Chief Secretary during the summer, and by additional Civil Service manpower cuts.

24. Taxation - full indexation of direct and indirect taxes is assumed for all years. For 1981-82, revalorisation takes about £1 billion off revenues. We assume that the existing PRT regime continues.

FORECASTS OF THE UK

The PSBR Table E

25. 1980-81 - Between April and the end of September, the borrowing requirement of the central government amounted to about £7¼bn, compared to a figure of £6½bn in the first half of the 1979-80 financial year. Information on the borrowing requirement of the public sector as a whole is less up-to-date, but we think that the PSBR in the first half of the current financial year amounted to about £8bn. These figures are not seasonally adjusted. For the year as a whole, the PSBR may emerge in the range of £8¾-12¾bn : £10¾bn is our central estimate. Again on an unadjusted basis, the PSBR in the October-December quarter might be some £3bn; and in the January-March quarter a net repayment of some £½bn. This low figure reflects some seasonal factors, such as corporation tax and PRT receipts, as well as EEC refunds, sales of assets, and forward oil sales.

26. Even though we know, within a fairly small margin, the size of the CGBR for the first half of the financial year, and have a good deal of information about the PSBR as a whole for this period, the forecast for the complete year remains subject to a wide margin of error.

27. 1981-82 - On the policy assumptions as specified for this forecast, and on the basis of our forecasts of income, activity, interest rates etc our central estimate of the PSBR for 1981-82 is £11bn. Previous experience suggests that this figure could be several billions wrong in either direction.

28. The table below illustrates, in a rough and ready way, how the PSBR next year could be different if policy assumptions or other parts of the forecast were varied. Each line shows the forecast PSBR resulting from a single change: because of interactions, it would not necessarily be right to combine various elements in the table.

	£ billion
Central estimate, on specified policy assumptions	11¼
(i) with pay in the public services rising at the same rate as in the rest of the economy	11¼
(ii) with nationalised industries' prices rising (from the beginning of the year) in line with other retail prices.	11¼
(iii) with no revalorisation of direct or indirect taxes	10¼
(iv) with the level of output 2% lower in 1981	13¼
(v) with the level of output 2% higher in 1981	9¼

Details of the PSBR forecast, and of public expenditure, are given in Appendix 1.

28a. The PSBR in 1980-81 is now put over £2 billion higher than in the Budget forecast. The main elements in the upward revision are as follows:

	£ billion
Extra borrowing by local authorities	0.9
Extra borrowing by public corporations	0.7
Shortfall on VAT and other customs receipts	1.1
Shortfall on expected special sales of assets	0.2
Extra social security benefits because of higher unemployment	0.3
Increase in defence cash limit	0.2
EC refunds	-0.4
Extra receipts of income tax	-0.6
Total	2.4
Other changes, net	-0.2
Total change in the forecast PSBR	2.2

The Money Supply and Interest Rates — Chart 3, Table C

29. Recorded £M3 grew by 26% at an annual rate between February and August, well above the top end of the target range. Adjusting for distortions associated with the corset the growth rate over this period was somewhat less than this, perhaps 22%, but even on this basis further growth of only about 2% is possible by April 1981 if "adjusted" monetary growth is to be within the current target range.

30. The forecast has been prepared on the assumption that recorded £M3 will grow at an annual rate of about 15% from February 1980 to April 1981. On this basis we would forecast that short term interest rates would have to be maintained at their present level. The growth of £M3 after adjusting for estimates of known distortions would be slightly - perhaps 1 per cent - above the top end of the target range. The slowdown in the PSBR+ in the second half of 1980-81 to a little over £3 billion, compared with nearly £7½ billion in the first half, is a major influence. Substantial sales of national savings - perhaps around £2 billion - following the recent announcement of a new index linked savings certificate is another. Furthermore, some slowing down in bank lending is probable as inflation falls and activity declines further, although recent experience has taught us to be cautious in this area.

31. These factors alone might be expected to lead to low or even negative monetary growth in the second half of the year if the momentum of gilt sales can be maintained, but there is one factor tending to offset them. With negligible monetary growth the banks' balance sheets would become even more skewed towards lending to the private sector given that the latter will continue to grow. Some restructuring of their balance sheets would in any case probably occur following the ending of the corset, adding to the growth of the money supply. Although an attempt to forecast the scale of this effect is extremely hazardous we have allowed an additional 2% on the money supply for this effect. Public sector assets made up 24 per cent of banks' total sterling assets in the first quarter of 1979. By the second quarter of 1980 the share had fallen to 22 per cent. We assume that the scope for a further fall is limited and indeed that the banks would prefer to move back to a higher public sector proportion (and hence to a more liquid asset structure). In the forecast the share is 18½ per cent in the first quarter of 1981 and 19½ per cent a year later.

+ seasonally adjusted, financial year constrained.

32. After the end of this financial year monetary policy is expected to remain extremely tight if the monetary growth numbers in the MTFS are adhered to. Nominal GDP is expected to grow by over 11% in 1981-82 and by over 10½% in 1982-83, compared with monetary targets of 8% and 7% respectively. Although the PSBR is forecast to decline as a share of GDP the private sector is forecast to accumulate net financial assets faster than the target rate of monetary growth in both years. In addition, attempts by the banks to restructure their balance sheets will add further to upward pressure on interest rates.

33. But there are factors which will tend to offset this upward pressure. The recent initiative on national savings is assumed to be carried forward: we have interpreted this to mean that the increase in the share of the personal sector surplus flowing into national savings expected in the last 4 months or so of 1980-81 is broadly maintained thereafter. The prospect of declining monetary growth and inflation should itself lead to expectations that interest rates will fall, and this will tend to boost gilt sales for any given level of long term interest rates.

34. Although there are enormous uncertainties, our central forecast is that there will be no decline in short term rates from current levels before the end of 1981. In part this reflects the fact that, as this year, the PSBR in 1981-82 may well be concentrated in the first three quarters of the year. Moreover because of the rise in the composite tax rate, the mortgage rate may have to rise from 15% to 16% in April 1981. Long term rates are forecast to decline by slightly over 1 point to about 12% by the end of 1981 reflecting declining inflation expectations and the effect of the national savings initiative on the need to sell gilts.

35. In 1982 some slight decline in short rates is forecast, perhaps to about 14½% by the end of the year, with long rates declining by a further point to about 11%. At this level of long term rates one might expect some resurgence of activity in the long term capital markets, and we have allowed for this in the forecast. Indeed one might expect some increase in activity before the end of 1981. But the main direct effect of this,

however, will be to take some pressure off bank lending, and hence the structure of banks' balance sheets. There might be little direct effect on the money supply as the increased supply of corporate long term debt reduces institutional demand for public sector debt, although there may be some indirect benefit because banks will need to expand their balance sheets by less in order to achieve a satisfactory balance sheet structure.

The exchange rate

36. The exchange rate has been remarkably strong this year and particularly over the summer months. This is partly due to the favourable interest rate differential though this has been eroded recently by the rise in US rates. Sterling has attracted sizeable inflows from OPEC countries and the current account has also been firm. Although there is a great deal of uncertainty about the future course of the exchange rate, we expect on balance that these influences will keep it firm over the next twelve months. Thereafter sterling could ease as the current surplus disappears and OPEC inflows diminish. However the exchange rate is still underpinned by high interest rates and the effective index could still be above the 70 mark at the end of 1982.

37. An alternative forecast in which the exchange rate falls over 10% during 1981 is summarized in table 1 and explained at greater length in appendix 3.

Inflation Chart 1, Tables F and G

38. We think that competitive pressures on prices in 1980 have arisen from the efforts of domestic producers to cut stocks and to try and match the prices of importers, in the face of a growing realization that inflation was likely to come down. In the first three quarters of this year, retail prices rose 2½% less than the usual relationship with import and wage costs would suggest; and home prices of manufactures rose 3½% less. Thus the rise in retail prices in the year to the third quarter of 1980 was only 16½%; without the cut in margins, it would have been 19%. Most forecasters, including ourselves, failed to foresee the extent of this fall in margins. For the next year or so, we think that firms will still not be able to pass on into prices on the domestic market all their increases in costs. In coming to this very uncertain judgment, we have been influenced by the strength of the exchange rate in 1981 and by continued destocking. During 1982, when output is no longer forecast to decline, we very tentatively assume that firms are able to restore their margins some way to the end-1979 level.

39. The recent falling off in the rate of price rises has direct implications for wages. Firstly, the year-on-year increase in the RPI has come down to 16½%, with a further moderation very likely from the start of 1981; secondly, firms have in effect cut back price increases in advance of securing a lower rate of pay settlements. Hence the pressures have grown on both sides in the wage bargain to settle at a lower level. Additional pressures are the exposed position of many exporting firms, and the direct and indirect threats of bankruptcies and unemployment - both rising strongly. Thus the signs are that wage settlements in the current pay round should be much lower than in the last round. But we are starting from a position in which average earnings in the private sector in the third quarter of this year were probably 20% higher than a year earlier, and without the sharp fall in overtime, the figure would have been 22%. Thus for most people real earnings have continued to rise. For the current pay round - in which there are as yet almost no settlements - we are forecasting average settlements as follows:

Settlements	%
manufacturing, retailing, catering	10
transport (private)	12
other private sector	14
public corporations	15
public services - policy assumption & special cases	9½
Total (weighted average)	11½

With the allowance of a further 1% for the usual tendency of earnings growth to exceed wage settlements, we forecast earnings to rise 12½% over the current pay round.

40. These forecasts take into account, as best we can, the strong downward pressure on settlements arising from firm's ability, or inability, to pay (pressure which varies considerably between sectors); but also some resistance to cuts in real wages.

41. The consequence of these forecasts of pay, and other costs, and profit margins for the general rate of inflation are set out in the table below:

percentage changes over a year earlier

	Earnings, total economy	Retail Prices	Wholesale output prices	Real take-home pay
1980 second half	20½	16½	17	1½
1981 second half	11½	13½	11	-2
1982 second half	8½	11	10½	-3

42. These forecasts of pay and prices imply that real after tax earnings will fall about 2% over the next year; and by a further 3% over the following year. Such falls have not taken place before in our post-war history, except very temporarily during periods of incomes policy; but the present and forecast position is exceptional, not just in the level of unemployment, but also in the pressures being imposed on company profitability. This judgment on real earnings receives some support from recent research which suggests that it is possible to discern from the muddied waters of the past fifteen years

some quite powerful effects from output and unemployment onto the level of real wages.

Spending and saving in the private sector   Chart 6, Tables H and J

43. In the personal sector, real disposable incomes rose an exceptional 14½% between 1977 and 1979. As usual, not all this increase was reflected in higher spending and by 1979 the savings ratio - much revised by the CSO's latest estimates - had risen to nearly 14% from an average of 12% in the 1973-78 period. High wage increases sustained real incomes in the first half of 1980, but the prospect over the whole of the forecast period is for slow declines in real incomes, mainly as a result of the forecast falls in real earnings (see paragraphs 41-42). We expect the savings ratio to fall next year : partly because of the usual tendency to cushion the impact on spending of a fall in real incomes, partly because the rate of inflation is coming down (and so, it may be argued, there is less erosion of the real value of wealth through inflation). Personal sector investment, mainly in dwellings, falls this year as a result of high interest rates and other costs, in the face of only slowly rising house prices; but a slow recovery could take place beginning next year. The forecast for a declining level of saving, even in nominal terms, and for rising capital expenditure points to the personal sector's financial surplus becoming appreciably smaller : such a move seems to be one of the necessary counterparts to a declining public sector deficit. By contrast, the ratio of personal sector financial wealth to its income rises slowly.

44. In the company sector, profitability has been falling since 1978, and particularly this year - or so we believe : we have discounted the high CSO/Inland Revenue figures for profits in the first half of this year (figures that are subject to major revision). With rising interest and dividend payments, companies' disposable income this year has probably been falling in nominal terms. Spending by companies is not usually related as closely to income as it is in the personal sector : last year saw an 8% rise in the volume of industrial investment (excluding ships and North Sea), and further additions to stocks. As a result, the company sector swung £4 billion, from a small financial surplus in 1978, to a sizeable deficit in 1979. More significant than the financial deficit is the

(better measured) borrowing requirement of companies : for the industrial and commercial sector this widened to a quarterly rate of £1½ billion last year and to £4 billion in the first quarter of 1980. These borrowing needs were financed partly from the banks and partly from reducing liquid assets. In consequence, the liquidity position of companies has been deteriorating since 1978. By early 1980 the financial position of the (non-North Sea) company sector was under severe pressure, and was a major contributor to the reappraisal of future prospects that took place in the spring of this year.

45. The necessary readjustments are under way : reducing stocks, cutting back investment spending (though the scope in the short term, except by way of extra leasing, is limited), shedding labour, and preparing for much lower pay settlements. The high PSBR and monetary growth in the last six months have provided some amelioration of what would otherwise have been an even sharper reappraisal; the converse is probably that pressures on companies to cut prices and to settle for low wage settlements have not been as severe as they otherwise would have been.

46. For the rest of this year and next year, companies will we think continue to seek to limit their borrowing needs, above all by further reductions in stocks. Some cutback in fixed investment is also likely : for private industry as a whole, the volume of investment spending is forecast to drop 3% in 1980 and 10% in 1981 with much of the drop in manufacturing. Even so, companies seem likely to remain in financial deficit and to generate borrowing needs which, unless and until they are able to issue sizeable stock in the debenture and/or equity market, will lead to further falls in their already low liquidity ratios.

<u>Financial balances</u> £bn

	Persons	Companies	Public	Overseas	Residual error
1979	11.0	-3.2	-8.3	1.9	- 1.4
1980	15.6	-2.2	-9.0	-1.2	- 3.2
1981	14.5	-2.8	-7.9	-0.6	- 3.2
1982	11.8	-1.1	-7.9	0.8	- 3.6

TABLE 2 : NOMINAL EXPENDITURES AND INCOMES, AT CURRENT PRICES

Percentage changes on a year earlier

	1979 Q4	1980 Q1	Q2	Q3	Q4	1981 Q4
<u>Expenditure</u>						
Personal Consumption	19	21	14	16	15	12
of which : retail sales	15	18	11	13++	N.A.	N.A.
Fixed investment	21	22	18	12	6	6
Public consumption	18	23	24	25	25	11
Exports of goods and services	21	36+	12	12	9	7
Imports of goods and services	27	25	9	6	0	11
<u>Income</u>						
Employment	19	19	20	19	15	8
Gross trading profits (exluding stock appreciation)	17	21	2	-11	0	12

+inflated by low 1979 Q1 figure because of strikes.

++July only.

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Trade and competitiveness   Chart 4, Table D

47. The summer forecast left unresolved the important issue of the extent to which trade performance would respond to the deterioration in competitiveness over the past few years. Since that forecast was completed, further information on 1980 has become available and, more significantly, we have re-examined our methodology, in the light of the UK's experience over the past 60 years, other countries' experience, and other economists' methods of evaluating the effects of competitiveness changes.

48. The general conclusions of this survey were that, for most countries and for most periods in the past, competitiveness changes were important in determining trade volumes, especially on the export side; that such changes took some years to have their full effect; and, very provisionally, that output in total (and not just of traded goods) was reduced by worsening competitiveness. We were not able, however, to find any earlier period, for the UK or elsewhere, in which the change in competitiveness was as large as it has been in the UK recently : so our conclusions on the likely effects remain very tentative - we could be seriously wrong in either direction.

49. 1980 has been a reminder that difficulties in analysing and forecasting trade are not confined to competitiveness effects. In the case of exports, estimates for the first half of the year show a rapid and unexpected rise in the volume of world trade in manufactures, and a fall in the UK's share. Chart 4 shows world trade in manufactures, UK exports and net index of effective competitiveness. Although the share of UK exports in world trade has fallen this year in volume terms, the continued rise in UK export prices relative to our competitors has resulted in our value share being well maintained. Imports, however, particularly of manufactures, have turned out much lower than anticipated. The response to the weakening of domestic demand has been sharper, and to competitiveness perhaps weaker, than expected.

50. With world trade forecast to grow only slowly in the second half of this year and through next year, the prospects for UK exports would in any event be poor. The extent of the worsening of competitiveness can be seen from the following table:

Competitiveness, 1975=100, manufacturing

	Relative labour costs	Relative export prices	Effective competitiveness relevant to exports
1979	111	114	95
1980	135	124	102
1981	144	125	115
1982	141	124	130

51. The third column takes account of the lags between changes in relative costs and subsequent changes in export volumes. The table shows that although there is only a moderate worsening of competitiveness from now on - a higher increase in UK rates of inflation than foreign rates offset, but only in 1982, by a decline in the exchange rate - the impact on exports continues to mount. The lagged effects of declining competitiveness, working through both supply and demand, are sufficient we think to cause a 6% fall in the volume of manufactured exports in 1981 and a further fall in 1982. But we could be very wrong about this in either directions: a variant, described in appendix 3, looks at the implications of a better trade performance.

52. On imports, recent experience and further research (now embodied in the model) suggests that the volume of imports may be more responsive to demand and less to competitiveness than we previously thought. Even so, it is not easy to explain all the fall in imports of finished manufactures this year : for this forecast we have revised downwards our view of the level of import penetration in the future.

Output and employment Chart 5, Table I

53. The table below shows the most recent estimates of output and employment, with our forecast for the third quarter.

1975=100

	Total economy		Manufacturing	
	GDP constant prices	Employment	Output	Employment
1979 First half	110½	100½	105	95½
second half	110	100	103½	94½
1980 first quarter	109½	99½	100	93
second quarter	107½	98½	97	91
third quarter	106½	97½	95½	89

54. By the third quarter of 1980, much of the fall in total GDP was accounted for by manufacturing; and so too, we think, was much of the fall in employment. Further falls in manufacturing output and employment in the fourth quarter of this year are strongly indicated by recent CBI enquiries.

55. For 1980 as a whole, GDP volume may be 3% down, close to the FSBR forecast in aggregate. Much of this fall is explained by decisions of manufacturers and distributors to cut back on stocks. Next year may well see further, but not perhaps larger, reductions in stocks but the weakness in export performance, as some firms find it unprofitable to provide the supply, is the main factor in the 2½% fall forecast for GDP. The table below summarises the forecasts of demand and output, in terms of contribution to GDP, measured as percentages of GDP.

<u>Percentage changes, constant prices</u>

	Contributions to GDP growth	
	1979 to 1980	1980 to 1981
Private domestic demand		
personal consumption	¼	0
fixed investment	0	-¾
stocks	-3¼	¼
Public expenditure on goods and services	-¼	-¾
Net trade	+¾	-1½
Total output	-2¾	-2½
Contribution of North Sea oil	+¼	+¼

The ¼% growth of total output contributed by North Sea oil corresponds to increases in production in that sector of about 10% in each year.

56. <u>Employment</u> is currently falling rapidly in manufacturing, and probably, more slowly elsewhere. Unemployment is rising fast, even though some of those losing their jobs do not seem to be registering as unemployed.

57. Our forecast for employment over the period of this forecast allows for a further rapid fall in manufacturing, and slower falls in the rest of the private sector and in the public sector. The forecast is dominated by the falls in output and hence in the demand for labour. Despite the recession, productivity has been well maintained - firms having shed labour rather more than usual this year - and we see a slow rise over the forecast period.

58. The prospect of falling employment and slowly rising labour supply (the population of working age continues to rise by ½-1% a year) leads to a continuing rise forecast for unemployment, though not as sharp as in the last three months.

59. In the past, we and other forecasters have made enormous errors in forecasting unemployment, more often than not overstating the actual levels. Our present forecast, also subject to a large margin of error, is that seasonally adjusted unemployment, having risen from a little over 5% of the employed labour force at the end of 1979 to nearly 7½% by September 1980 will rise to around 10% by the end of 1981. On the central forecast, and on the two alternative forecasts which show higher output, unemployment is forecast to be in excess of 10% in 1982.

APPENDIX 1: Table 3

Public expenditure reconciliation between forecast and Cmnd 7841

(The following table is at 1980 Survey prices and analyses the differences between the revalued planning total in Cmnd 7841 and the planning total implicit in the forecast.)

£bn @ 1980 Survey prices

	1980-81	1981-82
(a) Cmnd 7841 revalued		
(i) Expenditure on programmes	78.4	76.7
(ii) Less lending to nationalised industries (prog.5)	-0.8	-0.2
(iii) Contingency Reserve	1.1	1.3
(iv) Total borrowing by nationalised industries	0.7	-0.1
(v) Special sales of assets	-0.5	-0.1
(vi) Planning total before shortfall ((i)+(ii)+(iii)+(iv)+(v))	78.9	77.7
(b) Differences between Cmnd 7841 and forecast		
(i) EEC renegotiation	-0.4	-0.6
(ii) Chief Secretary's proposals	-	-0.1
(iii) Changed assumption on asset sales	+0.1	-0.2
(iv) Cash limit squeeze	-0.5	-
(v) Other exogenous shortfall	-0.2	-0.4
(vi) Differences due to economic assumptions etc	+0.2	+0.4
(c) Implicit planning total in forecast		
(i) Forecast adjusted for coverage differences (including shortfall) a(vi)-b(i)-b(ii)-b(iii)-b(iv)-b(v)-b(vi)	78.1	76.8

NB. Individual items may not sum to totals because of rounding.

TABLE 4

PSBR in 1980-81 and 1981-82

£bn not seasonally adjusted

	PSBR	of which:			of which:		
		CGBR	LA market and overseas borrowing	PC market and overseas borrowing	CG own account borrowing	LA total borrowing	PC total borrowing
1980 2	4.9	4.6	0.6	-0.2	3.3	0.6	1.0
3	3.0	3.0*	0.1	-0.1	1.7	0.4	1.0
4	3.2	3.2	-0.1	0	2.0	0.4	0.8
1981 1	-0.4	-1.1	0.8	-0.1	-1.7	0.9	0.3
1980/81	10.7	9.7	1.4	-0.4	5.3	2.3	3.1
1981/82	11.3	10.9	0.8	-0.4	7.7	1.8	1.8

* Information available since the forecast was completed indicates the CGBR in 1980(3) may have been £3.2bn

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APPENDIX 2: COMPARISONS OF FORECASTS

Table 5 shows a comparison of the current forecast with earlier forecasts. The first column shows the FSBR forecasts and the second the low output case of the summer forecast. The most important change since the earlier forecast is the laxer fiscal and monetary stance in 1980/81. These developments are discussed in more detail in the relevant sections of the report.

2. The prospect for price inflation this year is now very close to the FSBR forecast. To some extent this is a validation of the judgments made at that time, but it appears to be the result of higher pay (correctly forecast in the summer) offset by a higher exchange rate and a compression of margins. The prospect for next year remains closer to the summer forecast than that made at FSBR time. This arises mainly from the higher pay forecast for this year.

3. The picture for output this year has changed little since the FSBR forecasts (or indeed the Industry Act forecast last autumn). The decline of 2½-3% in GDP has been a fairly general feature. For next year, prospects lie somewhere between the two earlier forecasts. The improvement in inflation is the major factor in mitigating the effect of restrictive government policy and adverse competitiveness. Within this total, the cumulative fall in manufacturing output this year and next, also lies between the two forecasts, but more of the fall is now expected to occur this year.

4. The largest revisions to the forecasts have been to sectoral balances. We have revised our view of the current account by about £3½bn this year and £1½bn next. This is partly the result of the recent impressive performance of net trade, and partly of revisions to the IPD balance in earlier years. Revisions to past data also played a role in the change in judgment on Industrial and Commercial companies' financial deficit. Equally important, however, is the change in our view of the nature of the recession. The fall in output now appears in a reduction in stock levels rather than a decline in net exports. The company sector has anticipated the effects of adverse competitiveness on its finances and has shifted the financial burden onto the overseas sector.

APPENDIX 3

Alternative forecasts

1. Two alternative forecasts have been constructed. One envisages a substantially better trading performance, the other a sharper and earlier fall in the exchange rate.

(a) Better trade

This forecast supposes that for the same picture of competitiveness and world trade the performance of UK exports and imports of goods and services will be some 3% better by the end of 1981 and 4½% by the end of 1982 than the central projection. Such a difference could arise from a variety of factors including a different estimate of the impact of competitiveness, of time trends, of response to domestic and world activity or a combination of these. While the initial stimulus from output comes from increased net exports, this effect is soon replaced by increased consumption. This arises from the higher earnings stimulated by higher activity and the lower price inflation arising from a higher exchange rate. There is some improvement in inflation and in company profits net of stock appreciation; after 1981 increased profits are more than disbursed, giving an adverse movement in the ICC's financial balance. The PSBR is improved by about £¼bn in 1981/82 and £2¼bn in 1982/83. The effects are broadly as illustrated in table 1 of the main text.

(b) Lower exchange rate

The implications of an alternative exchange rate path were examined. This was assumed to derive from a collapse of confidence in sterling, so that the path emerges with the same level of official intervention and the same overseas interest rates.

Exchange Rate

	Central Forecast	Variant
1980 4	75.5	71.0
1981 1	75.5	69.0
2	75.5	68.3
3	75.0	67.7
4	74.5	67.5
1982 1	73.5	66.5
2	73.0	65.5
3	72.0	64.5
4	71.5	64.5
1983 1	71.0	64.5

The alternative forecast has the now familiar features of increased output and higher inflation. Because the difference in the exchange rate increases during 1981, there is a long "J curve". The effect on the PSBR is very small. The current balance may not improve therefore for the first six months or so after the collapse in the exchange rate. Company profits are higher almost immediately and their financial deficit improves.

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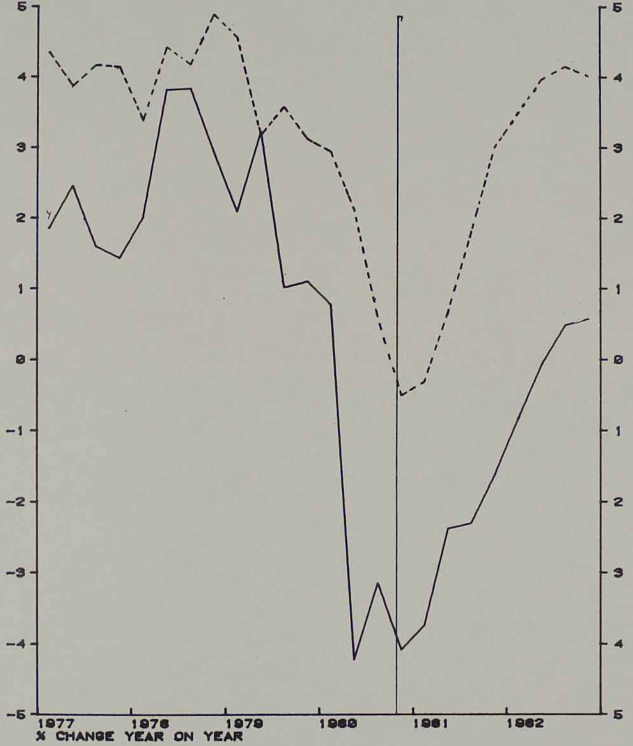
CHART 1: UK OUTPUT AND WORLD OUTPUT



---------- GNP - 6 major countries)
) % change on a year earlier
————UKGDP)

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CHART 2: INFLATION

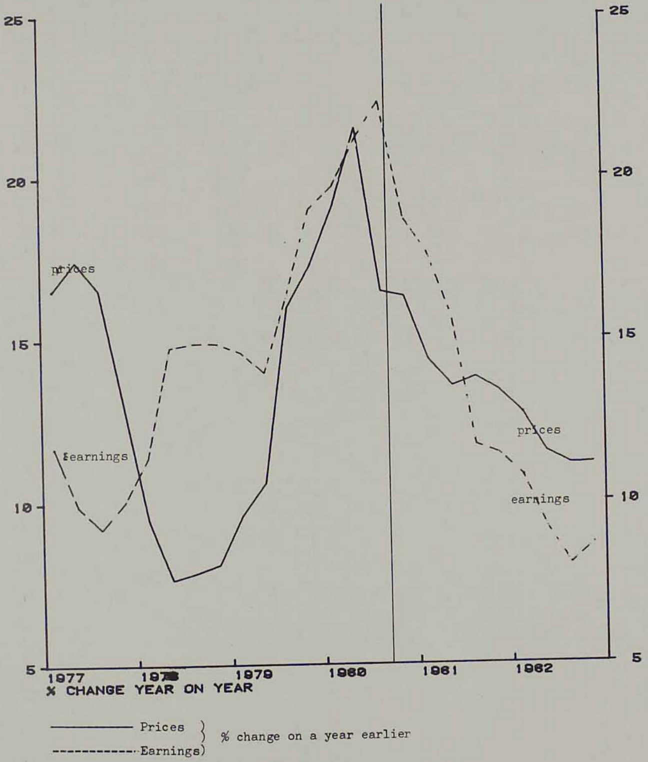

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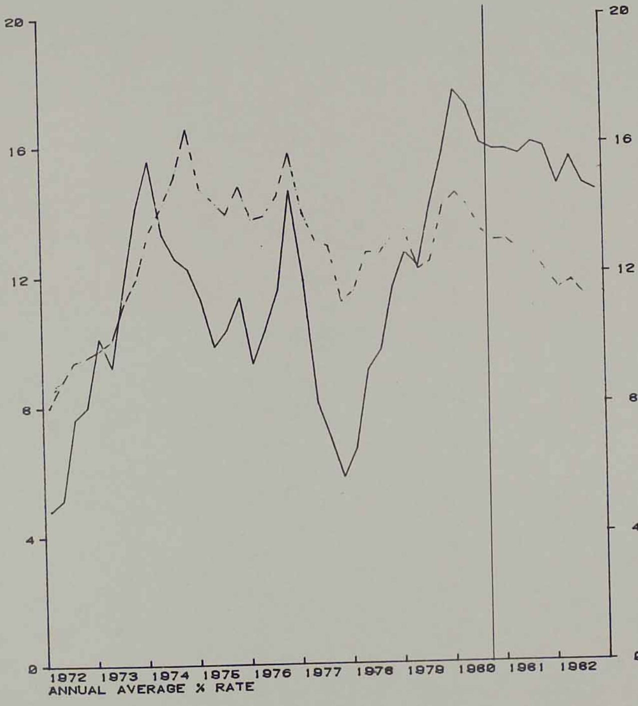
CHART 3: INTEREST RATES



---------- long rate

———————— short rate

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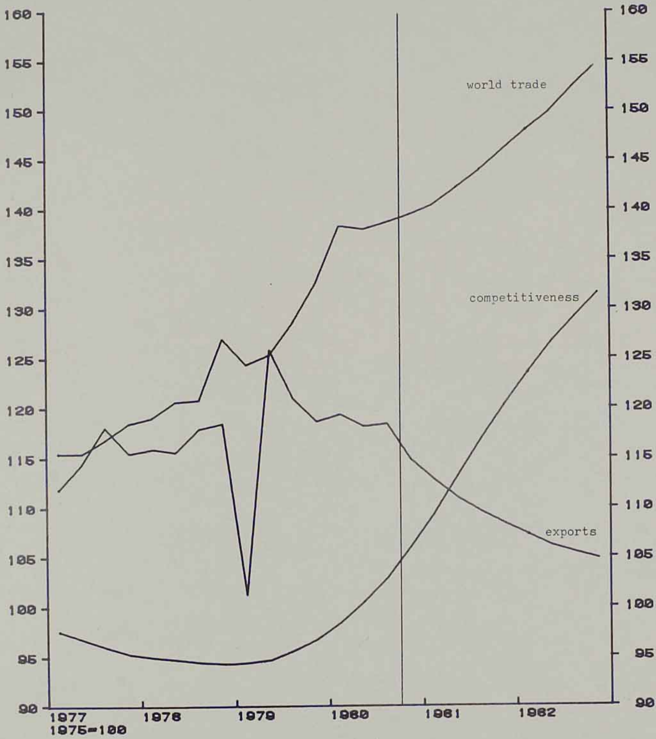
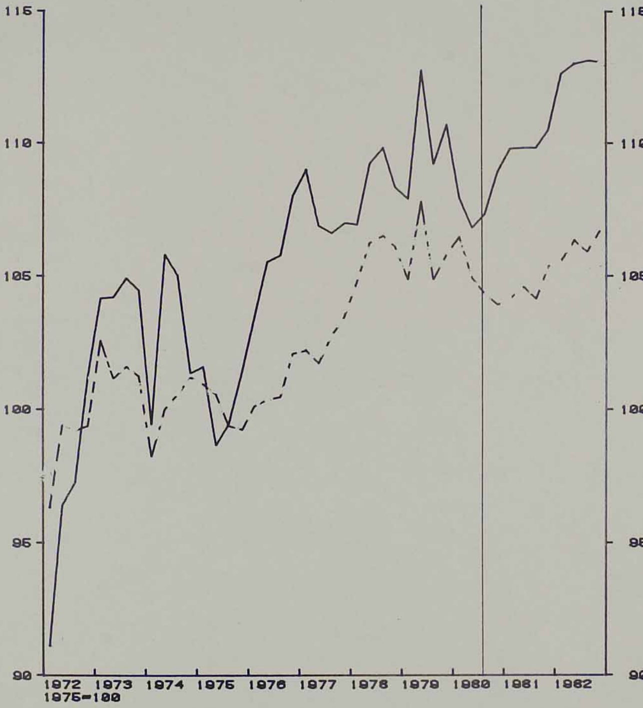
CHART 4: TRADE AND COMPETITIVENESS



World trade is UK weighted world trade in manufactures.
Competitiveness is effective relative unit labour costs - ie the competitiveness retimed as it affects exports according to the model equation.
Exports are UK exports of manufactures less erratics.

CHART 5:PRODUCTIVITY



Output per employee ———————— manufacturing

1975=100 ------------ other private sector

CHART 6: COMPANY FINANCE AND STOCKS

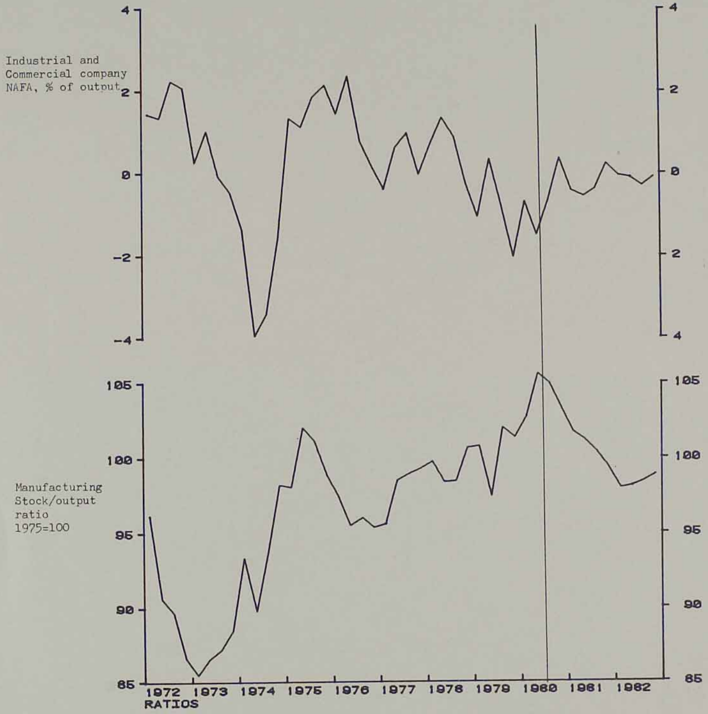


TABLE A SUMMARY

	1 GDP AT CONSTANT PRICES 1975=100	2 RPI% CHANGE OVER PREV. YEAR	3 EARNINGS % CHANGE OVER PREVIOUS YEAR	4 PSBR(1)	5 CURRENT BALANCE	6 PSBR/ GDPM* (1)(2)	7 ICC'S NAFA (3)	8 EXCHANGE RATES EFFECTIVE EXCH.RATE	9 DOLLAR/£ RATE	10 INTEREST RATES 3-MONTH INTER BANK	11 20-YEAR GILTS
1978	108.2	8.3	15.3	8267	620	5.04	337	63.00	1.920	9.23	12.49
1979	110.2	13.4	17.1	12109	-1863	6.31	-3404	67.80	2.122	13.66	12.99
1980	107.2	18.3	20.9	9515	1243	4.26	-2477	74.37	2.326	16.65	13.71
1981	104.5	13.8	14.4	10637	647	4.26	-2457	75.12	2.400	15.70	12.60
1982	104.5	11.5	8.9	9670	-788	3.50	-1002	72.50	2.387	14.87	11.40
1978/79	108.7	8.3	16.0	8694	-74	5.15	-867	62.65	1.942	10.74	12.95
1979/80	110.4	15.8	18.1	9900	-1060	5.04	-2809	69.80	2.182	14.91	13.27
1980/81	106.1	17.0	20.2	10666	2083	4.74	-2636	75.25	2.363	16.19	13.34
1981/82	104.2	13.4	12.7	11251	156	4.44	-1880	74.62	2.398	15.52	12.25
1982/83	104.5	11.1	8.4	9411	-745	3.34	-1277	71.88	2.388	14.60	11.17
1978 QTR 1	106.3	9.5	13.4	1823	-271	4.71	106	65.40	1.928	6.63	11.52
QTR 2	108.6	7.6	16.6	1764	351	4.37	293	61.50	1.836	9.05	12.68
QTR 3	108.6	7.8	15.4	2066	139	4.96	208	62.40	1.932	9.67	12.63
QTR 4	109.1	8.1	15.8	2614	401	6.12	-270	62.70	1.985	11.59	13.14
1979 QTR 1	108.5	9.6	16.2	2250	-965	5.15	-1098	64.00	2.015	12.67	13.35
QTR 2	112.1	10.6	14.9	2971	-264	6.30	-133	67.40	2.081	12.22	12.13
QTR 3	109.7	16.0	17.6	3668	5	7.46	-695	71.00	2.233	14.08	12.38
QTR 4	110.3	17.3	19.4	3220	-639	6.32	-1478	68.80	2.159	15.69	14.10
1980 QTR 1	109.4	19.1	20.1	41	-162	0.08	-503	72.00	2.254	17.66	14.48
QTR 2	107.3	21.5	21.6	4297	-68	7.90	-1244	74.60	2.285	17.16	14.05
QTR 3	106.3	16.5	22.6	3156	581	5.57	-770	75.40	2.382	16.00	13.30
QTR 4	105.8	16.3	19.3	2021	892	3.48	41	75.50	2.381	15.80	13.00
1981 QTR 1	105.2	14.3	17.5	1192	678	2.01	-662	75.50	2.405	15.80	13.00
QTR 2	104.8	13.8	16.3	3558	99	5.78	-916	75.50	2.405	15.70	12.80
QTR 3	103.8	13.8	12.8	2897	-135	4.61	-775	75.00	2.398	15.70	12.50
QTR 4	104.0	13.3	11.5	2990	5	4.64	-102	74.50	2.393	15.60	12.10
1982 QTR 1	104.3	12.6	10.5	1806	187	2.74	-85	73.50	2.396	15.10	11.60
QTR 2	104.7	11.2	9.0	2840	-370	4.16	-385	73.00	2.394	15.10	11.50
QTR 3	104.3	11.2	7.9	2504	-482	3.58	-411	72.00	2.378	14.80	11.30
QTR 4	104.6	11.2	8.5	2520	-123	3.52	-119	71.50	2.381	14.50	11.20
1983 QTR 1	104.3	11.0	8.3	1547	230	2.12	-360	71.00	2.399	14.00	10.70

(1) FINANCIAL YEAR SEASONALLY ADJUSTED
(2) PSBR as a percentage of GDP at current prices
(3) Financial balance of industrial and commercial companies

TABLE 8 SUMMARY (PART II)

PERCENTAGE CHANGES ON PREVIOUS YEAR (EXCEPT COL. 12)

	1 TFE DEFLATOR	2 REAL TFE	3 REAL GDP	4 NOMINAL GDPM	5 PRIVATE SECTOR FINANCIAL WEALTH EXCLUDING REVALUATIONS	6	7 PRIVATE SECTOR FINANCIAL WEALTH INCLUDING REVALUATIONS	8	9 BANK LENDING TO PRIVATE SECTOR	10 PRIVATE SECTOR HOLDINGS OF GILTS	11	12	13 £M3	14 REAL MONEY SUPPLY	15 M1
					NET	GROSS	NET	GROSS		EXCL. REVALS.	INCL. REVALS.	AS A % OF GROSS WEALTH			
1978 QTR 1	9.31	3.82	2.00	14.89	8.35	16.03	10.55	17.46	11.88	16.08	19.58	41.52	14.51	4.75	23.05
QTR 2	8.76	3.34	3.81	15.55	10.87	14.40	11.17	14.58	13.46	16.86	17.33	40.44	14.64	5.40	20.18
QTR 3	8.37	4.30	3.83	14.77	11.44	12.75	2.89	7.23	14.39	11.95	-0.58	40.84	15.20	6.30	18.09
QTR 4	9.05	3.27	2.92	14.24	13.41	11.74	5.11	6.51	15.21	10.33	-1.66	40.30	15.20	5.64	16.67
1979 QTR 1	9.57	1.12	2.08	12.98	15.09	13.32	16.89	14.42	20.02	14.31	16.96	42.45	11.64	1.89	13.20
QTR 2	11.12	5.74	3.23	16.80	13.79	15.76	15.06	16.54	21.19	17.01	18.93	41.27	12.77	1.48	12.73
QTR 3	14.70	2.17	1.01	17.96	13.18	16.58	15.56	18.06	22.96	18.52	22.13	42.25	13.15	-1.35	11.01
QTR 4	16.30	3.45	1.11	19.37	12.51	17.75	7.06	14.37	23.85	21.32	12.91	39.79	13.37	-2.52	10.10
1980 QTR 1	17.90	3.14	0.77	20.60	13.21	14.14	2.06	7.16	22.65	18.59	2.16	40.46	12.88	-4.25	6.78
QTR 2	18.55	-3.76	-4.23	15.28	16.49	14.68	14.11	13.25	22.65	18.30	14.85	41.86	15.43	-2.63	7.34
QTR 3	16.25	-2.78	-3.15	15.19	17.20	17.14	15.68	16.21	23.24	18.87	16.68	42.42	18.68	2.09	5.97
QTR 4	15.23	-3.98	-4.12	13.80	20.63	16.50	27.88	20.72	22.26	17.68	28.29	42.28	18.15	2.54	2.20
1981 QTR 1	13.71	-3.33	-3.77	12.59	19.55	16.92	27.07	21.40	18.93	17.77	28.86	42.95	16.11	2.11	2.73
QTR 2	12.63	-1.80	-2.39	13.12	17.22	14.11	20.69	16.20	14.76	16.26	21.27	43.68	11.35	-1.14	2.31
QTR 3	11.78	-0.71	-2.32	10.91	14.80	10.91	17.50	12.55	10.92	12.46	16.31	43.84	7.42	-3.90	2.62
QTR 4	11.91	-0.88	-1.65	11.03	13.42	10.23	17.39	12.68	9.07	11.72	17.51	44.09	5.87	-5.39	4.47
1982 QTR 1	11.54	-0.17	-0.88	11.17	13.61	9.99	19.90	13.90	8.24	8.52	17.64	44.36	8.00	-3.17	7.14
QTR 2	10.88	0.49	-0.09	11.07	12.74	9.02	18.52	12.65	7.57	6.19	14.48	44.39	7.75	-2.83	7.77
QTR 3	10.65	0.90	0.46	11.14	11.66	7.92	17.03	11.30	6.82	5.09	12.81	44.43	7.50	-2.85	7.88
QTR 4	10.62	1.10	0.60	11.31	10.36	7.20	14.37	9.78	6.65	4.01	9.86	44.13	7.25	-3.05	8.70
1983 QTR 1	10.60	0.69	-0.04	10.67	8.90	6.81	13.10	9.56	6.60	3.24	9.45	44.31	7.00	-3.25	9.98

TABLE C DCE AND MONEY SUPPLY SUMMARY TABLE

$ MILLION AT CURRENT PRICES, SEASONALLY ADJUSTED

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
		SALES OF PUB. SECTOR DEBT TO NON BANKS			BANK LENDING				EXT. & FOREIGN CURR. FINANCE	NON-DEP LIABS.		INCR. IN £M3	------VELOCITY OF £M3------			
	PSBR	GILTS	NATSAV	OTHER	PRIV. SECTOR	OVER-SEAS	RES.	DCE			RES.		GDP BASED	GNP BASED	% CHG GDP BASED	% CHG GNP BASED
1978	8267	4304	1525	164	4693	1062	33	8062	-378	915	-29	6740	3.35	3.42	-0.04	0.63
1979	12109	8740	844	1063	8806	-14	236	10490	-2839	818	-3	6830	3.47	3.48	3.65	1.68
1980	9515	8183	1564	-953	10610	2269	330	13930	-1876	1428	-113	10513	3.46	3.48	-0.24	0.02
1981	10637	6959	3968	-755	5028	167	246	5906	-748	1140	0	4018	3.52	3.51	1.74	1.08
1982	9670	2798	2879	94	4019	222	-3	8137	-1632	1254	0	5251	3.64	3.63	3.30	3.35
1978/79	8694	5714	1618	1144	6367	334	441	7360	-964	965	9	5440	3.36	3.40	0.20	-0.56
1979/80	9900	8682	754	-526	9622	491	-119	10984	-2679	1476	-109	6720	3.53	3.52	5.02	3.45
1980/81	10666	8478	2389	-1277	8734	1992	472	12274	-1674	1085	-27	9488	3.44	3.45	-2.50	-1.86
1981/82	11251	5238	3515	-182	4683	50	169	7582	-944	1167	-1	5470	3.55	3.55	3.18	2.62
1982/83	9411	2341	2757	475	4056	277	-2	8169	-1715	1285	1	5170	3.67	3.66	3.42	3.32
1978 QTR 1	1823	448	422	299	758	646	-119	1939	378	-90	-17	2390	3.31	3.41	0.33	3.09
QTR 2	1764	1576	348	-439	1641	294	161	2375	-659	342	-14	1360	3.36	3.40	0.79	0.92
QTR 3	2066	1166	470	155	1106	47	235	1663	-157	334	-2	1170	3.39	3.44	-0.37	-0.23
QTR 4	2614	1114	285	149	1188	75	-244	2085	60	329	4	1820	3.34	3.42	-0.84	-1.16
1979 QTR 1	2250	1858	515	1279	2432	-82	289	1237	-208	-40	21	1090	3.35	3.35	1.20	-1.76
QTR 2	2971	2506	184	67	2370	-22	56	2618	-216	350	8	2060	3.48	3.51	3.58	3.03
QTR 3	3668	2035	125	167	2176	91	45	3653	-1557	576	-10	1510	3.53	3.54	4.25	2.88
QTR 4	3220	2341	20	-450	1828	-1	-154	2982	-858	-68	-22	2170	3.52	3.51	5.29	2.57
1980 QTR 1	41	1800	425	-310	3248	423	-66	1731	-48	618	-85	980	3.58	3.53	6.83	5.38
QTR 2	4297	2325	144	267	2627	606	122	4916	-1153	25	-28	3710	3.47	3.47	-0.13	-0.88
QTR 3	3156	2880	245	-543	2954	940	99	4567	-500	517	0	3550	3.43	3.48	-2.93	-1.80
QTR 4	2021	1178	750	-367	1781	300	175	2716	-175	268	0	2273	3.39	3.42	-3.68	-2.37
1981 QTR 1	1192	2095	1250	-634	1371	146	77	75	154	274	0	-45	3.47	3.44	-3.03	-2.40
QTR 2	3558	2522	990	-107	1374	98	169	1794	-183	281	0	1329	3.53	3.53	1.59	1.46
QTR 3	2897	1408	869	-7	1332	-8	2	1953	-311	288	0	1354	3.54	3.53	3.25	1.63
QTR 4	2990	934	859	-7	948	-69	0	2083	-407	295	0	1380	3.56	3.55	4.87	3.71
1982 QTR 1	1806	374	797	-61	1026	29	0	1751	-41	302	0	1407	3.57	3.57	2.93	3.70
QTR 2	2840	1287	712	-3	1095	124	0	2063	-494	309	0	1259	3.64	3.63	3.08	2.85
QTR 3	2504	824	675	38	985	86	0	2038	-439	317	0	1281	3.66	3.65	3.39	3.15
QTR 4	2520	313	695	120	909	-17	-1	2283	-655	324	0	1303	3.69	3.68	3.78	3.72
1983 QTR 1	1547	-83	675	320	1064	83	0	1782	-124	332	0	1325	3.70	3.70	3.43	3.56

COL 1 CALENDAR YEAR SEASONALLY ADJUSTED
COL 2 COMPRISES GILTS, LONG TERM LA DEBT AND PC DEBT
COL 4 COMPRISES TREASURY BILLS, LA TEMPORARY DEBT AND OTHER CG DEBT
COL 8 = COL1-(COL2+COL3+COL4)+COL5+COL6+COL7
COL13 = COL8+COL9-COL10
GDP-BASED £M3 IS THE RATIO OF GDP AT CURRENT MARKET PRICES EXPRESSED AT AN ANNUAL RATE TO £M3
GNP-BASED £M3 IS THE RATIO OF GNP AT CURRENT MARKET PRICES EXPRESSED AT AN ANNUAL RATE TO THE CENTRED QUARTERLY AVERAGE OF £M3
COLS 15 AND 16 ARE % CHANGES OVER PREVIOUS YEAR

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TABLE D EXCHANGE RATES AND COMPETITIVENESS

	1	2	3	4	5
	EXCHANGE RATES		COMPETITIVENESS		
			EXPORTS OF MANUFACTURES		
	EFFECTIVE EXCH.RATE	DOLLAR/£ EXCH.RATE	REL.WHS. PRICES	PRICE COMPET	REL.UNIT. LAB.COST.
1978	63.00	1.920	100.88	106.38	93.45
1979	67.80	2.122	113.23	113.68	110.83
1980	74.37	2.326	130.68	124.37	135.37
1981	75.12	2.400	136.94	124.64	143.58
1982	72.50	2.387	136.02	124.12	140.89
1978 QTR 1	65.40	1.928	104.28	109.28	93.87
QTR 2	61.50	1.836	98.51	102.47	91.77
QTR 3	62.40	1.932	100.09	106.29	92.88
QTR 4	62.70	1.985	100.63	107.47	95.28
1979 QTR 1	64.00	2.015	103.66	108.85	100.16
QTR 2	67.40	2.081	111.84	113.04	109.48
QTR 3	71.00	2.233	120.28	118.31	117.37
QTR 4	68.80	2.159	117.14	114.53	116.32
1980 QTR 1	72.00	2.254	125.93	121.98	127.44
QTR 2	74.60	2.285	129.97	123.52	134.47
QTR 3	75.40	2.382	132.61	127.20	139.85
QTR 4	75.50	2.381	134.22	124.76	139.74
1981 QTR 1	75.50	2.405	135.76	124.52	141.74
QTR 2	75.50	2.405	137.18	125.00	145.45
QTR 3	75.00	2.398	137.36	124.56	144.35
QTR 4	74.50	2.393	137.44	124.46	142.78
1982 QTR 1	73.50	2.396	136.21	124.13	142.17
QTR 2	73.00	2.394	136.13	124.52	142.38
QTR 3	72.00	2.378	135.58	123.49	139.98
QTR 4	71.50	2.381	136.16	124.35	139.02
1983 QTR 1	71.00	2.399	136.11	124.15	139.38

TABLE E PUBLIC SECTOR - CURRENT AND CAPITAL ACCOUNTS - PART C

	1	2	3	4	5	6	7
	PSBR	- -OF WHICH:- -			- -OF WHICH:- -		
		CG COMP	LA COMP	PC COMP	CG OWN AC BORR	LA TOT BORR	PC TOT BORR
1978	8267	8320	640	-693	6089	1064	1114
1979	12109	9585	2097	427	5951	2505	3653
1980	9515	8486	1847	-818	4060	2860	2595
1981	10637	10262	800	-425	7103	1823	1711
1982	9670	9270	800	-400	6328	1790	1552
1978/79	8694	8004	612	78	5886	949	1859
1979/80	9900	8199	2126	-425	4230	2943	2727
1980/81	10666	9664	1389	-387	5247	2299	3120
1981/82	11251	10851	800	-400	7650	1762	1839
1982/83	9411	9011	800	-400	6327	1835	1249
1978 QTR 1	1823	1641	657	-475	1139	752	-67
QTR 2	1764	2021	-42	-215	1529	-1	237
QTR 3	2066	2130	176	-240	1487	321	258
QTR 4	2614	2528	-151	237	1934	-6	687
1979 QTR 1	2250	1325	629	296	936	637	677
QTR 2	2971	2595	407	-31	1807	619	545
QTR 3	3668	2795	728	145	1728	777	1163
QTR 4	3220	2870	333	17	1480	472	1268
1980 QTR 1	41	-60	658	-556	-784	1075	-248
QTR 2	4297	2999	1221	77	1937	997	1363
QTR 3	3156	3278	73	-195	1868	433	855
QTR 4	2021	2270	-105	-144	1040	355	626
1981 QTR 1	1192	1117	200	-125	402	514	276
QTR 2	3558	3458	200	-100	2358	688	512
QTR 3	2897	2797	200	-100	2021	434	442
QTR 4	2990	2890	200	-100	2322	187	481
1982 QTR 1	1806	1706	200	-100	949	453	404
QTR 2	2840	2740	200	-100	1899	430	510
QTR 3	2504	2404	200	-100	1698	444	361
QTR 4	2520	2420	200	-100	1780	463	277
1983 QTR 1	1547	1447	200	-100	948	498	101

ALL VARIABLES ARE FINANCIAL YEAR SEASONALLY ADJUSTED

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TABLE F: RETAIL PRICES INDEX AND CONSUMERS EXPENDITURE DEFLATOR

RECORDED AND FORECAST

	1	2	3	4	5	6	7	8	9	10	11	12
	RETAIL PRICES INDEX JANUARY 1974=100					PERCENTAGE CHANGES OVER LAST YEAR FOR RETAIL PRICE INDEX AND COMPONENTS					CONS.EXPD.DEFLATOR (SEAS. ADJ.)	
	FOOD	HOUSING	NAT.IND.	OTHER	TOTAL	FOOD	HOUSING	NAT.IND.	OTHER	TOTAL	INDEX 1975=100	P-C CH ON PREV.YEAR
WEIGHTS(1)	221	131	79	569	1000							
1978	203.8	173.3	227.2	195.7	197.1	7.1	7.1	9.2	9.0	8.3	144.5	8.6
1979	228.3	208.9	246.7	221.9	223.5	12.0	20.5	8.6	13.4	13.4	162.1	12.2
1980	257.0	270.1	306.5	260.0	264.3	12.6	29.3	24.3	17.2	18.3	188.4	16.2
1981	284.7	327.5	375.1	290.6	300.8	10.8	21.2	22.4	11.7	13.8	213.2	13.2
1982	309.6	375.7	434.1	322.6	335.5	8.7	14.7	15.7	11.0	11.5	236.5	10.9
1978 QTR 1	197.3	162.9	221.1	190.1	190.6	6.8	5.2	11.2	11.4	9.5	140.5	10.1
QTR 2	203.8	171.2	226.0	194.2	195.8	6.7	3.8	8.9	8.9	7.6	143.3	8.5
QTR 3	206.2	176.8	230.2	197.3	199.2	7.3	7.7	9.2	7.9	7.8	145.8	7.8
QTR 4	208.0	182.4	231.7	201.1	202.6	7.6	11.6	7.6	7.8	8.1	148.4	8.3
1979 QTR 1	218.8	191.5	235.3	205.5	208.9	10.9	17.6	6.4	8.1	9.6	152.6	8.6
QTR 2	225.2	207.7	238.8	212.2	216.6	10.5	21.3	5.7	9.3	10.6	157.1	9.7
QTR 3	231.9	215.4	250.1	231.7	231.1	12.5	21.8	8.6	17.5	16.0	166.9	14.5
QTR 4	237.2	220.9	262.6	238.1	237.6	14.1	21.1	13.3	18.4	17.3	171.9	15.8
1980 QTR 1	247.5	241.0	278.9	246.8	248.8	13.1	25.8	18.5	20.1	19.1	178.2	16.7
QTR 2	255.9	272.3	300.3	258.9	263.2	13.6	31.1	25.8	22.0	21.5	185.6	18.1
QTR 3	260.1	278.8	315.2	264.1	269.1	12.2	29.5	26.0	14.0	16.5	192.4	15.3
QTR 4	264.5	288.4	331.7	270.4	276.3	11.5	30.6	26.3	13.6	16.3	197.4	14.9
1981 QTR 1	275.0	294.0	350.9	276.7	284.5	11.1	22.0	25.8	12.1	14.3	203.1	14.0
QTR 2	284.2	331.0	366.6	288.9	299.5	11.1	21.6	22.1	11.6	13.8	210.6	13.5
QTR 3	287.3	337.4	385.0	295.3	306.1	10.5	21.0	22.1	11.8	13.8	217.1	12.9
QTR 4	292.5	347.5	397.9	301.4	313.1	10.6	20.5	20.0	11.5	13.3	221.8	12.4
1982 QTR 1	301.3	353.3	409.8	307.9	320.4	9.6	20.2	16.8	11.3	12.6	226.8	11.7
QTR 2	308.5	377.2	423.2	320.2	333.2	8.5	13.9	15.4	10.8	11.2	233.6	11.0
QTR 3	311.7	381.3	444.2	327.6	340.3	8.5	13.0	15.4	10.9	11.2	240.3	10.7
QTR 4	317.2	390.9	459.1	334.9	348.1	8.4	12.5	15.4	11.1	11.2	245.2	10.5
1983 QTR 1	325.5	394.4	472.2	342.5	355.8	8.0	11.6	15.2	11.2	11.0	251.1	10.7

(1) THESE WEIGHTS ARE APPLICABLE TO INDICES BASED ON JANUARY 1974 = 100

TABLE G WAGE AND SALARY BILL (1)

SEASONALLY ADJUSTED
RECORDED AND FORECAST

	1	2	3	4	5	6	7	8	9	10	11	12
	--AVERAGE WAGES AND SALARIES--						RL DISP		PUBLIC/ PRIVATE	W+S	TOTAL TREND	MFG TREND
	TOTAL	CENTRAL	LOCAL	PUBLIC(2)	CYC.(5) PRIV	PRIVATE	AVERAGE W+S(3)	% CHNG	DIFF '75=100	BILL '75=100	LABOUR COSTS	LABOUR COSTS
1978	14.0	9.5	11.3	10.3	15.3	15.0	99.1	6.8	90.5	142.2	14.3	14.0
1979	16.1	13.8	13.4	13.4	17.1	16.7	102.7	3.6	87.6	165.0	16.8	16.0
1980	20.5	30.8	26.2	28.5	20.9	18.4	104.0	1.3	93.2	198.7	19.2	18.7
1981	14.0	12.6	17.2	15.7	14.4	13.7	103.7	-0.3	93.9	226.5	13.6	12.3
1982	9.1	8.9	8.9	9.0	8.9	9.1	101.8	-1.8	94.0	247.1	8.2	8.0
1978 QTR 1	11.4	6.9	8.6	7.8	13.4	12.4	95.5	4.2	89.9	134.3	12.9	12.4
QTR 2	14.8	7.1	12.6	9.9	16.6	16.1	97.2	8.3	90.9	140.8	14.6	14.0
QTR 3	14.9	13.5	11.6	12.5	15.4	15.6	102.1	9.3	92.8	144.9	14.4	14.5
QTR 4	14.9	10.2	12.4	11.3	15.8	15.8	101.8	5.7	88.3	148.7	15.3	14.9
1979 QTR 1	14.6	8.1	9.0	8.5	16.2	16.2	101.6	6.4	84.0	153.9	16.8	15.5
QTR 2	14.0	13.7	6.3	9.7	14.9	15.1	100.7	3.6	86.8	160.5	14.7	14.9
QTR 3	16.4	14.2	20.4	17.4	17.6	16.1	102.2	0.1	92.6	168.6	17.6	16.9
QTR 4	19.0	18.7	17.1	17.9	19.4	19.3	106.3	4.5	87.2	177.0	18.0	16.6
1980 QTR 1	19.7	30.2	22.0	25.9	20.1	18.2	101.6	0.0	88.1	184.2	18.4	18.6
QTR 2	21.2	30.5	25.9	28.3	21.6	19.4	103.0	2.3	91.6	194.4	20.7	19.2
QTR 3	22.3	33.4	23.6	28.5	22.6	20.6	106.4	4.1	97.0	206.3	20.2	19.5
QTR 4	18.7	29.2	32.8	31.4	19.3	15.5	105.1	-1.2	96.1	210.1	17.7	17.4
1981 QTR 1	17.6	19.7	29.1	24.8	17.5	15.8	102.9	1.3	93.5	216.7	16.4	15.0
QTR 2	15.7	14.0	23.3	18.9	16.3	14.8	104.3	1.2	93.6	224.9	15.0	13.6
QTR 3	11.7	6.4	10.8	8.8	12.8	12.6	104.3	-2.0	93.6	230.4	12.3	10.8
QTR 4	11.4	11.5	9.0	10.3	11.5	11.7	103.2	-1.7	95.1	234.0	11.1	10.0
1982 QTR 1	10.7	10.5	10.5	10.5	10.5	10.8	103.2	0.3	93.6	239.9	10.0	9.3
QTR 2	9.1	9.0	9.0	9.0	9.0	9.2	102.3	-1.9	93.6	245.4	8.1	7.8
QTR 3	8.0	7.9	7.9	8.0	7.9	8.0	101.1	-3.0	93.6	248.8	7.2	7.3
QTR 4	8.6	8.5	8.5	8.5	8.5	8.7	100.6	-2.5	95.1	254.3	7.8	7.8
1983 QTR 1	8.4	8.3	8.3	8.3	8.3	8.4	100.4	-2.7	93.6	260.0	7.7	7.6

(1) THE WAGE AND SALARY BILL AND AVERAGE WAGE AND SALARY FIGURES IN THIS TABLE INCLUDE FORCES PAY
(2) PUBLIC REFERS TO NON-TRADING PUBLIC AUTH. AND PRIVATE TO THE REST
(3) THIS MEASURE OF REAL TAKE-HOME PAY IS DEFLATED BY THE RETAIL PRICES INDEX
(4) COLUMNS 1, 2, 3, 4, 5, 6, 8, 11 AND 12 ARE EXPRESSED AS PERCENTAGE CHANGES ON THE PREVIOUS YEAR
COLUMNS 9 AND 10 ARE INDICES WHERE 1975=100
(5) PUBLIC SECTOR EARNINGS ADJUSTED FOR CHANGES IN OVERTIME ETC

TABLE H SUMMARY OF EXPENDITURE

AT 1975 PRICES, SEASONALLY ADJUSTED
£ MILLION

	1 CONS EXPDT	2 PUBLIC AUTH CONS	3 FIXED INV	4 EXPORTS GOODS + SERVICE	5 INV STOCKS	6 COMPR ADJ	7 TOTAL FINAL EXPDT	8 IMPORTS GOODS + SERVICE	9 FACTOR COST ADT	10 GDP AT FACTOR COST	11 GDP INDEX 1975=100	12 GDP-OIL INDEX 1975=100
1978	68074	23864	20802	32037	843	-415	145620	31773	11919	101513	108.2	105.9
1979	70816	24334	20506	32896	1609	837	150161	35254	12349	103395	110.2	106.9
1980	70996	24458	20204	33445	-1787	848	147316	35034	12530	100600	107.2	103.7
1981	70965	24443	18792	32254	-1636	800	144818	35260	12315	98043	104.5	100.7
1982	70986	24555	18352	32020	-258	800	145655	36078	12317	98060	104.5	100.2
1978 QTR 1	16748	5916	5287	7971	185	-208	36107	8008	2941	24950	106.3	104.4
QTR 2	16844	5949	5282	7901	306	-120	36282	7749	2936	25477	108.6	106.3
QTR 3	17210	5968	5136	8098	206	-22	36618	8078	3032	25486	108.6	106.3
QTR 4	17272	6031	5097	8067	146	-65	36613	7938	3010	25600	109.1	106.5
1979 QTR 1	17406	6024	4998	7410	672	348	36510	8276	3113	25469	108.5	105.5
QTR 2	18242	6088	5052	8664	318	134	38364	8992	3207	26299	112.1	108.8
QTR 3	17417	6121	5182	8411	280	235	37411	8972	2930	25744	109.7	106.3
QTR 4	17751	6101	5274	8411	339	120	37876	9014	3099	25883	110.3	107.0
1980 QTR 1	18072	6130	5167	8614	-327	345	37656	8960	3377	25664	109.4	106.0
QTR 2	17634	6136	5076	8287	-212	59	36921	8810	2984	25186	107.3	104.1
QTR 3	17570	6097	5032	8272	-599	294	36372	8656	3076	24934	106.3	102.9
QTR 4	17720	6095	4929	8271	-649	150	36366	8607	3093	24816	105.8	102.0
1981 QTR 1	17749	6095	4845	8165	-456	200	36398	8816	3087	24695	105.2	101.5
QTR 2	17794	6117	4693	8059	-408	200	36255	8785	3086	24584	104.8	101.0
QTR 3	17752	6112	4636	8024	-411	200	36113	8880	3076	24357	103.8	100.0
QTR 4	17670	6117	4618	8003	-361	200	36047	8777	3063	24407	104.0	100.2
1982 QTR 1	17804	6131	4556	7981	-136	200	36336	8977	3081	24478	104.3	100.3
QTR 2	17821	6144	4579	7973	-85	200	36432	8984	3087	24561	104.7	100.5
QTR 3	17678	6138	4604	8022	-5	200	36437	9098	3071	24468	104.3	100.0
QTR 4	17683	6140	4613	8042	-32	200	36446	9018	3075	24553	104.6	100.2
1983 QTR 1	17785	6142	4619	8057	-18	200	36585	9227	3091	24467	104.3	99.8

TABLE I OUTPUT AND PRODUCTIVITY BY SECTOR

AT 1975 PRICES SEASONALLY ADJUSTED
INDICES: 1975=100

	1	2	3	4	5	6	7	8	9	10	11	12
	O U T P U T						PRODUCTIVITY (OUTPUT/EMPLOYMENT)					
				-PRIVATE + TRADING PUBL.-						-PRIVATE + TRADING PUBLIC-		
	WHOLE ECON-OMY	EXCLUDING N.SEA OIL	PUBL.NON TRADING (1)	MANU-FAC.	NS.OIL + GAS	OTHER	WHOLE ECON-OMY	EXCLUDING N.SEA OIL	PUBLIC NON TRADING (1)	MANU-FAC.	NS. OIL + GAS	OTHER (2)
WEIGHT IN TOTAL	1000		156	281	0	563						
1978	108.4	106.1	105.8	104.3	21646.5	107.1	108.5	106.3	103.8	108.3	9277.1	105.9
1979	110.2	106.9	106.7	104.4	31141.4	108.3	109.9	106.7	103.7	109.8	11324.2	105.8
1980	107.2	103.8	105.6	96.9	32884.6	106.7	109.1	105.6	103.6	107.4	9990.3	104.9
1981	104.5	100.7	105.1	92.4	36101.7	103.6	109.9	106.0	104.1	109.7	10830.5	104.5
1982	104.5	100.3	103.8	90.5	40233.8	104.2	112.3	107.9	104.7	112.6	12070.2	106.1
1978 QTR1	106.7	104.8	105.3	103.2	18303.0	105.4	107.1	105.2	103.8	106.6	8447.6	104.8
QTR2	108.6	106.3	105.5	105.1	21292.9	107.2	108.8	106.6	103.7	108.9	9125.5	106.2
QTR3	109.2	106.9	106.0	105.4	22181.8	107.8	109.3	107.0	103.9	109.5	9506.5	106.5
QTR4	109.1	106.5	106.5	103.6	24808.1	107.9	108.9	106.3	103.7	108.0	9923.2	106.1
1979 QTR1	108.6	105.5	105.4	102.9	29090.9	106.9	108.3	105.3	102.5	107.6	11636.4	104.9
QTR2	112.1	108.8	106.8	107.3	31596.0	110.1	111.8	108.5	103.7	112.5	11848.5	107.8
QTR3	109.8	106.3	107.2	103.5	32888.9	107.5	109.4	106.0	104.1	108.9	11607.8	104.9
QTR4	110.4	107.1	107.2	103.8	30989.9	108.7	110.2	107.0	104.4	110.4	10330.0	105.8
1980 QTR1	109.4	106.0	106.0	100.0	32282.8	109.0	109.8	106.5	103.2	107.6	10194.6	106.5
QTR2	107.4	104.1	105.8	97.2	31191.9	107.1	108.6	105.4	103.6	106.5	9357.6	104.9
QTR3	106.3	102.9	105.3	95.5	32234.0	105.9	108.6	105.2	103.7	107.1	9670.2	104.3
QTR4	105.8	102.0	105.1	95.0	35829.7	104.7	109.2	105.4	103.8	108.6	10748.9	103.9
1981 QTR1	105.3	101.6	105.3	94.5	35362.1	104.1	109.5	105.7	104.0	109.5	10608.6	104.1
QTR2	104.8	101.0	105.3	93.0	35920.3	103.9	109.9	106.0	104.1	109.5	10776.1	104.6
QTR3	103.9	100.0	105.1	91.6	36410.1	102.8	109.7	105.7	104.2	109.5	10923.0	104.1
QTR4	104.1	100.2	104.9	90.7	36714.4	103.6	110.7	106.6	104.3	110.2	11014.3	105.3
1982 QTR1	104.4	100.3	104.6	91.3	38392.1	103.6	111.6	107.3	104.5	112.3	11517.6	105.5
QTR2	104.7	100.5	104.1	90.8	39782.6	104.4	112.4	108.0	104.6	112.7	11934.8	106.3
QTR3	104.3	100.0	103.5	90.2	40880.3	103.9	112.4	107.8	104.8	112.8	12264.1	105.9
QTR4	104.7	100.3	103.2	89.4	41880.4	104.9	113.1	108.4	105.0	112.8	12564.1	106.7
1983 QTR1	104.3	99.9	102.8	89.1	42360.0	104.4	113.0	108.3	105.3	113.3	12708.0	106.2

(1) DIRECT EMPLOYMENT COMPONENT OF LA & CG CEGS; (2) INCLUDES SELF-EMPLOYED FOR WHOLE ECONOMY IN DENOMINATOR

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TABLE J FACTOR INCOMES - SHARES

PERCENTAGE OF TOTAL DOMESTIC INCOME NET OF STOCK APPRECIATION

	1 INCOME FROM EMPL-OYMENT	2 INCOME FROM SELF EMPLMT.	3 ..NET COMPANY NON-OIL	4 PROFITS.. OIL	5 PUBLIC CORP.ETC NET SUR-PLUSES	6 RENT	7 TOTAL DOMST. INCOME (1)
1978	67.9	8.7	10.4	1.6	3.6	7.8	100.0
1979	69.0	8.7	8.7	2.9	3.0	7.7	100.0
1980	70.7	8.3	6.4	3.8	2.9	7.9	100.0
1981	70.2	8.1	5.7	4.0	3.8	8.2	100.0
1982	67.7	8.0	7.3	4.6	4.2	8.2	100.0
1978 QTR 1	68.1	8.7	10.3	1.6	3.4	7.9	100.0
QTR 2	67.5	8.7	10.7	1.6	3.9	7.7	100.0
QTR 3	67.6	8.8	10.7	1.5	3.6	7.7	100.0
QTR 4	68.2	8.8	9.8	1.8	3.5	7.9	100.0
1979 QTR 1	69.5	8.9	8.2	2.4	3.1	7.9	100.0
QTR 2	68.1	8.8	9.4	2.7	3.3	7.7	100.0
QTR 3	69.0	8.7	8.7	3.1	2.8	7.7	100.0
QTR 4	69.2	8.6	8.4	3.2	3.0	7.6	100.0
1980 QTR 1	70.0	8.6	7.0	3.8	2.9	7.7	100.0
QTR 2	70.4	8.5	7.0	3.6	2.7	7.8	100.0
QTR 3	72.0	8.2	5.5	3.7	2.7	8.0	100.0
QTR 4	70.4	8.1	6.3	4.0	3.2	8.0	100.0
1981 QTR 1	70.4	8.1	5.7	3.9	3.8	8.1	100.0
QTR 2	70.8	8.1	5.3	3.9	3.7	8.2	100.0
QTR 3	70.5	8.0	5.3	4.0	3.9	8.3	100.0
QTR 4	69.3	8.0	6.4	4.1	3.8	8.4	100.0
1982 QTR 1	68.6	8.1	6.6	4.3	4.1	8.3	100.0
QTR 2	68.1	8.1	7.2	4.5	4.0	8.2	100.0
QTR 3	67.3	8.0	7.4	4.7	4.3	8.2	100.0
QTR 4	66.8	7.9	7.7	4.8	4.5	8.3	100.0
1983 QTR 1	66.6	7.9	7.4	4.9	4.8	8.3	100.0

(1) NET OF STOCK APPRECIATION

CONFIDENTIAL

Econ Pol Strategy

Econ Pol

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

28 October 1980

Richard Dykes, Esq.,
Private Secretary,
Department of Employment

Dear Richard,

NEW EARNINGS SURVEY

The Chancellor has seen your Secretary of State's letter of 16 October about the first results of this year's New Earnings Survey.

He agrees that it is most unfortunate that the sensitive political issue of the presentation of public service pay, and in particular the pay of the non-industrial civil service was not considered at Ministerial level. He assumes that your Department have made arrangements to ensure that this is not repeated.

He is nevertheless in agreement with Mr. Prior's judgement that it is better to get the high Civil Service Settlement out of the way this year than to have it included in next year's Survey figures; and he notes from her Private Secretary's letter of 27 October that the Prime Minister is content for publication to go ahead without delay.

As to presentation, the Chancellor shares the Prime Minister's view that the Government should adopt a fairly robust attitude towards these figures. No doubt the significance of the catching up element, and the fact that public service employees have done relatively less well over a longer timescale can serve as useful defensive points; but we should equally make clear - as the Chancellor has done in recent speeches - that the public services have enjoyed substantial improvements in pay under the present Government, not to mention their other relative advantages in terms of job security and pension provision.

I am copying this letter to the Private Secretaries to the members of E Committee, and also to Jim Buckley (Lord President's Office), Richard Prescott (Paymaster-General's office) and David Wright (Cabinet Office).

Yours sincerely

John Wiggins

A.J. WIGGINS

CONFIDENTIAL

MR. INGHAM O/R

cc. Mr. Lankester
Mr. Vereker
Mr. Prescott (PMG's office)

New Earnings Survey

The original plan to cope with the problems of the Employment Gazette and the New Earnings Survey due to be published were:

(i) to issue the Gazette about 24 hours in advance under its normal embargo (for Wednesday at 2100 hours). The Gazette, as you know, will carry a summary of the NES including percentage increases for public services and the public sector as a whole;

(ii) to issue Part B of the New Earnings Survey containing percentage increases for broad civil service categories sometime on Wednesday afternoon, without embargo.

The hope was that the journalists would concentrate on the Gazette rather than the NES, Part B.

2. However, Department of Employment Information Division now tell me that a considerable number of detailed tables normally published in the Gazette (including tables showing percentage increases for civil service categories) are being excluded this year for the first time. D/Employment believe that the absence of these tables will leave them wide open to the misinterpretation that they are deliberately suppressing them. To avoid this risk, they now believe that they should ~~publish~~ release the NES, under embargo, at the same time as the Gazette.

3. I had to interrupt my conversation with D/Employment at this point. But before we allow them to go ahead on this basis I think:

(i) we need evidence from previous years that the particular detailed tables that are likely to

/cause

cause trouble this year have in the past attracted attention when they have been published in the Gazette;

(ii) we also need to find out whether they have previously made clear in the Gazette that the statistical material available in previous years in connection with the NES - or indeed any other regular series of statistics - were being dropped this year for whatever reason.

NG

NEVILLE GAFFIN
24 October, 1980

P.S. Mr. Mower, D/Em's Head of Information, answers:

3(i): Yes, the aficionados will want these tables and spot their absence.

3(ii): No, the absence of the sensitive tables from the Gazette has not previously been trailed.

I have also asked Mr. Mower why the sensitive tables have been left out of the Gazette. He said that this is to save space in the publication and give more space to the summary. It is also, of course, to encourage more people to buy the NES rather than, in effect, giving it to them as a free supplement in the Gazette. ~~Instead~~ I have asked: why not, therefore, put a note to editors in your press notice on the Gazette to that effect?

He also mentions that the Gazette refers to Part B as having "already been published" (as it would have been a week ago, had the current problems not been identified). However, the statement would still be technically true if they issued it without an embargo on Wednesday afternoon before the embargo on the Gazette is lifted at 2100 hours.

/Understandably,

Understandably, however, Mr. Mower feels D/Em will be open to enormous criticisms unless he makes the NES available, under embargo, at the same time as the Gazette.

I have said that we will consider and respond on Monday. D/Em's ultimate deadline is a.m. Tuesday.

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 21.00 HOURS ON WEDNESDAY, OCTOBER 29, 1980. THIS DOCUMENT IS ISSUED IN ADVANCE ON THE STRICT UNDERSTANDING THAT NO APPROACH IS MADE TO ANY ORGANISATION OR PERSON ABOUT ITS CONTENTS BEFORE THE TIME OF PUBLICATION.

October 29, 1980

PATTERNS OF PAY

Earnings are highlighted in this month's Employment Gazette* with special features on the New Earnings Survey for April 1980 and the June 1980 figures for manual male workers in shipbuilding, engineering and chemicals.

"Patterns of pay" gives the first results of this year's New Earnings Survey. It shows that between the 1979 and 1980 surveys, average gross weekly earnings of men aged over 21 in full-time jobs rose by just over 22 per cent to £124.50. For women over 18 in full-time jobs earnings rose by nearly 25 per cent to about £79.

Non-manual employees showed a larger percentage increase than manual workers: for men, this was 24½ per cent compared with 20 per cent; for women, just over 25 per cent compared with just under 23 per cent.

Changes in average earnings between successive surveys are influenced by the timing of pay settlements, so the 1980 figures must be seen in relation to earlier years.

For several large groups of employees, particularly in the public sector, all or part of two pay settlements were carried over and came into force between the 1979 and 1980 surveys. The percentage increases in earnings, therefore, reflect not only the latest pay settlement; but also earlier settlements not incorporated in the 1979 survey because they were delayed or phased.

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* Employment Gazette, October 1980; HMSO; Price £1.65

The article also points out the effect of lower overtime working on earnings; the fall between the 1979 and 1980 surveys was mainly caused by a drop in the number of people working overtime, rather than by lower hours for those working overtime.

It also notes recent changes in the average levels of women's and men's earnings and in the distribution of earnings. In the 1980 survey average gross hourly earnings of women, excluding overtime, were about 73½ per cent of those for men; this was slightly higher than in 1979.

Distribution of earnings changed relatively little, despite the substantial increase in average earnings.

INTER-PLANT PRODUCTIVITY AND EARNINGS

Many of our more productive companies could successfully compete with foreign firms, even though average productivity in Britain is below that in several major competitor countries, according to a new study reported in this month's Employment Gazette.

This, the first plant-level study of the 1973 Census of Production, looked at 15 key industries.

It found substantial variations in productivity between plants in the same industry; for example, in motor vehicles there were ten plants where output was below £1,000 per year per man, while there were just as many with a performance five times better.

In iron and steel, the three most productive plants had an average productivity more than 25 times higher than the three least productive.

A similar pattern was found in most industries and the authors say this wide variation shows that there might well be scope for increasing output.

For instance, if in 1973 all motor vehicle plants near the bottom of the productivity scale had improved performance to the level of those a quarter of the way up, total industry output would have risen by more than £150 million a year (12½ per cent). And if all plants had reached at least three-quarters of the way up the scale, output would have risen by at least £456 million (38 per cent).

The article also pointed out a strong positive connection between earnings and productivity, both between plants and industries. In textiles, for example, a rise in output per person per year from £1,840 to £3,000 was associated with a 15 per cent increase in earnings.

There could have been several reasons for this, including genuine productivity bargaining.

On the theme of earnings, the authors say the survival of the Meriden Co-operative as the last major British motor-cycle producer is partly due to the reductions in real wages which its members have accepted.

Other articles in this month's Employment Gazette include:

Homeworking: some new evidence (summarises a study carried out for the Department);

Employment rehabilitation: looking to the future of the employment rehabilitation service;

Night and day: a new report for those involved in altering or starting shift working;

French labour courts and unfair dismissal law: a short study of the French equivalents of our own system;

plus: latest skill shortage indicators and latest figures on applications to industrial tribunals under the Race Relations Act 1976.

NOTES TO EDITORS

1. "Patterns of pay" is intended only as an introduction to the wide range of information available in the reports on the New Earnings Survey. Part B which gives details for major collective agreements, wages boards and councils, is also published today. Part A, on sale in the next few weeks, will contain a full range of summary tables analysing earnings by industry, occupation, region etc. Each part is published by HMSO, price £7.90 net.

2. Starting this month, the presentation of regularly published statistics and statistical articles (such as the New Earnings Survey feature) in Employment Gazette has been revised. This takes into account many of the views expressed in a recent readership survey. All regular tables and charts, except those in special features, will now appear in an easy-to-follow centre section where both the monthly data and time series on a particular subject will appear together. A unique numbering system will provide an easy reference system. Some analyses, not published on a regular basis before, are being included. Among these are several international comparisons of prices, earnings and employment, and some extensions to unemployment statistics.

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Econ Pol.

MFJ

CC DOI MAFF
LPO DOT
PGO Mr Vereker
HO Mr Ingham
FCO Mr Hoskyns
CSD Mr Wolfson
DN
CS, HMT
CO
HMT - by special ness

10 DOWNING STREET

From the Private Secretary

27 October 1980

Dear Richard,

The Prime Minister was grateful for your Secretary of State's minute of 23 October about the New Earnings Survey 1980, the first results of which are to be published on 29 October.

The Prime Minister agrees that the earnings figures as produced by the statisticians, which include last year's Civil Service settlement even though it was not implemented until 7 May, must be accepted. But she has questioned the tone of the briefing note which was enclosed with Mr. Prior's minute. In her view, there is no point in trying to talk down the figures because, whatever is said by way of interpretation, it will not be believed. Rather than going on the defensive, she believes it would far better for Ministers to use the figures to demonstrate that no Government has given the public sector a better deal than this one, and that this favourable treatment cannot be allowed to continue unless and until the private sector recovers.

I am sending copies of this letter to John Wiggins (HM Treasury), Jim Buckley (Lord President's Office), Richard Prescott (Paymaster General's office), Richard Riley (Department of Industry) and to the Private Secretaries to all other members of E Committee (to whom I have asked you to send copies of Mr. Prior's minute) and also to David Wright (Cabinet Office).

Yours ever,

Tim Lankester.

Richard Dykes Esq
Department of Employment.

CONFIDENTIAL

6

CONFIDENTIAL

cc Mr. Hoskyns
Mr. Wolfson
Mr. Gaffin
Mr. Ingham (on return)

D

MR. LANKESTER

New Earnings Survey

Thank you for letting me see Mr. Prior's minute of 23 October, and the enclosure, about the forthcoming publication of the New Earnings Survey. We have known for some time that this particular louse was about to crawl out of the wood work; because of the potential adverse effect on private sector pay settlements, the problem was drawn to the attention of the Dixon Group at its last meeting, and the Department of Employment were asked to take whatever steps were necessary to straighten out the statistical nonsense. They failed to do so - apparently it would have involved a completely new set of sample interviews - but Mr. Prior did warn the Chancellor and the Paymaster General earlier this week that the problem was coming up, and arrangements were made to ensure that the figures in the new earnings survey would be published on the same day as an article explaining them in the Gazette, so that at least the media would only have one go at the issue.

I was shown Mr. Prior's minute and enclosure in draft, but the proposed briefing note still does not adequately reflect the point I made then, which is that neither the background nor the notes for use address themselves sufficiently clearly to the particular problem of central government pay rises. Accordingly I suggest the following amendments:

(i) A new paragraph to follow the existing paragraph 1, as follows:

This briefing is defensive. We do not want to draw more attention to the NES than it will otherwise attract, partly because the figures show high public sector increases (and may therefore discourage pay moderation in the private sector) and partly because, for statistical reasons, a proportion of the 1979 settlement has been aggregated with the whole of the 1980 settlement, so as to produce very high figures for central government.

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/ (ii)

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(ii) A new sentence to be added to the existing paragraph 7, as follows:

> And for statistical reasons, the NES figures do not in some cases reflect the annual pay settlements. In particular, in the figures for central government, a proportion of the 1979 settlement has been put together with the whole of the 1980 settlement.

(iii) Two new opening sentences to the existing paragraph 13 should be added, as follows:

> The NES figures show how much faster than the cost of living recent pay rises have been; that has led to a substantial real increase in living standards for which there has been no basis ~~for~~ in increased productivity. This time round, pay rises cannot keep pace with the rise in the cost of living.

J.

John Vereker

24 October 1980

CONFIDENTIAL

24 October 1980 C

MR LANKESTER

You asked for my comments on Jim Prior's note to the Prime Minister about "Earnings 1979-80".

We have just one brief and general comment. Jim seems to be mostly concerned (and by implication, Geoffrey Howe and Christopher Soames likewise) to "talk down" the New Earnings Survey because it contains such large figures.

This seems to be quite the wrong way round. If our objectives are to create a climate which is (a) conducive to low public sector settlements, and (b) which helps us to explain cause and effect to the public (these huge increases, including the private sector, have to be paid for in unemployment, high MLR, expenditure cuts, higher taxes), the high figures in the Survey strengthen our case. In any case, they are so horrendous, however we talk them down, compared with the realities of our situation, that we risk looking ridiculous if we appear to be investing great effort in making absurdly high figures look slightly less absurd. Better to say that we've all behaved like greedy idiots and are now paying the price, and it would be stupid and (in the public sector) wicked to sustain such behaviour for another year. And we're not going to let it happen.

This should be explicitly used as a launching-pad for announcement of Cash limits & the 6% objective

JOHN HOSKYNS

PRIME MINISTER

The minute from Jim Prior at Flag A brings to your attention a problem over the publication of the new earnings survey next Wednesday. It shows very large increases indeed in public sector pay between April 1979 and April 1980, including central government increases of 34½% (although this figure itself will not be public until mid-November).

You might also like to see some figures I have obtained from the Treasury on the pay bill of the public sector. They are attached at Flag B. They show that General Government pay (i.e. local and central government added together) has increased by 50% between calendar 1978 and calendar 1980.

John Hoskyns has commented (Flag C) that we should not "talk down" the new earnings survey figures. John Vereker (Flag D) has suggested some drafting amendments to the briefing note which seek to tone down the draft still further.

There is a split between those who think that publicity to the high public sector figures last year will help to bring down public sector settlements this winter, and those who fear that they may be used to bolster private sector settlements in this pay round.

What do you think? Are you in favour of John Vereker's suggested amendments, designed to counter the private sector risk?

MS

You cannot talk down ~~these~~ figures because whatever you say - you won't succeed. The figures speak for themselves So are their message - no government has given the public sector a better deal than this one. This cannot continue unless and until the private sector recovers its trade. MT.

24 October 1980

The Paybill of the Public Sector

£Bn	1978	1979	1980 (first half)	1980 (second half)	
General Government	20.4	23.4	13.8	16.0	30
Public Corporations	11.1	13.0	8	-	
Total	31.5	36.4	22	-	

CS

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Copied to
Public Sector Pay file

PRIME MINISTER

EARNINGS 1979-80

I have discussed with Geoffrey Howe and Christopher Soames the awkwardness we face on the publication of the first results of the New Earnings Survey 1980 on 29 October. The Survey compares the earnings of a large sample of workers in April 1979 and April 1980; and the results are always widely awaited.

2. The Survey shows that average earnings for adult men in the public sector as a whole increased by 25½% and in the public services (central and local government) by nearly 29%. The increase in the private sector was 20½%.

3. There is a presentational problem about the increase for central government which was particularly high at 34½%. This includes both the civil service and the health service. For the major groups within the non-industrial civil service increases ranged from 29% to 42%. These civil service increases include the two staged payments of around 5% and 10% which were part of the April 1979 settlement but which were not paid until August 1979 and January this year. They also include approximately 19% for this year's April settlement implementation of which was in fact deferred until 7 May in order to bring the cost within the cash limit. This inevitably gives a distorted picture because it includes the bulk of two annual settlements in the one year period covered by the 1980 Survey.

4. The increase implemented on 7 May might have been excluded as falling outside the Survey period; but the statisticians thought it right to include it as the deferment of its implementation was exceptional and this settlement traditionally comes into payment in April. Its exclusion, which would have needed to be noted, could well have attracted adverse comment and would have meant that, in a year's time, the 1981 Survey would have shown a very much higher figure than that we mean to achieve. In any case, it is not now practical to re-run the Survey to exclude the 1980 settlement.

5. Although Geoffrey Howe, Christopher Soames and I are agreed that we should have had the opportunity of giving political consideration to the option favoured by the statisticians before we reached this point, we are also agreed that the outcome has to be accepted and that we must now ensure that the figures are put in proper perspective on publication. This point has been taken into account in a short article on the Survey which will appear in the Department of Employment Gazette. I also attach a briefing note, prepared by our officials, which, if you agree, Angus Maude might circulate to all Ministers.

6. I am copying this minute to Geoffrey Howe, Christopher Soames and Angus Maude.

JP

23 OCTOBER 1980

BRIEFING NOTE FOR MINISTERS

[E]ARNINGS 1979-80

Background

The first results of the New Earnings Survey (NES) 1980 will be published on 29 October in the form of a short article in the Department of Employment Gazette and the first part of the separately published report on the Survey. Each year the Survey compares the earnings in April of a large sample of workers with their earnings in April of the previous year.

2. The article will show that although the average earnings of all adult men increased by 22½%, there was a significantly higher increase in the public sector (25½%) than in the private sector (20½%). Moreover it will show that within the public sector the increase for public services (central and local government) was nearly 29%. Although the breakdown between central and local government will not be published until mid-November, in the second part of the Survey report, the 29% comprises 34½% for central government and 26% for local government.

3. In addition the first part of the survey report will contain, inter alia, separate figures for the major groups within the non-industrial civil service. These show increases for matched groups of staff ranging from 29% to 42%.

4. The publication of these figures might well prompt criticism that whilst the Government has exhorted pay restraint it has in fact allowed public service pay, and in particular pay in the non-industrial civil service, to increase excessively.

5. There are however some statistical oddities in the Survey and it is important that the figures are put in proper perspective when they appear. The article in the Gazette will do this.

6. In addition the following briefing notes are provided to help Ministers counter any ill-based criticisms and to explain the Government's views.

NOTES FOR USE

7. It should come as no surprise that earnings in the public services increased sharply over the 12 months to April 1980.

8. The last Administration's pay policies had the effect of holding down pay in these services more than elsewhere. Before the 1979 Election the pressures thus

created were beginning to be released, for example with the setting up of the Clegg Commission and the restoration or introduction of the concept of comparability more generally. This all provided for an inevitable catching up process; the Government and the tax-payer being left to meet a very expensive post-dated cheque.

9. In fact, taking the last four of five years together, to even out the discriminatory effects of those pay policies, pay in the public services has increased no faster than pay in the private sector. For example, between 1976-1980 the earnings of all non-manual workers increased by 72% and the earnings of the non-industrial civil service by 71%.

10. The way in which a number of public service settlements in the 1978-79 pay round came to be staged has also helped to swell the apparent increases between the 1979 and 1980 earnings surveys. The purpose was to reduce the short-term costs of the settlements. But the result was that the 1979 Survey earnings figures appear artifically low in comparison with the 1980 figures.

11. The increases in earnings between the survey dates do not always indicate the effect of a single annual pay settlement, whether staged or not. For example, in the case of the non-industrial civil service, the increases shown between the two latest surveys include staged payments from the 1979 settlement (only the initial payment of which is reflected in the 1979 survey) of around 5% and 10%, which were paid respectively in August 1979 and January 1980. And they also include the 1980 settlement which, although traditionally due in April, was this year not implemented until 7 May. The effects of much the greater part of two annual settlements are therefore evident in the earnings increase for the service.

12. The catching-up process is past history. The Comparability Commission is being wound up. Public services' pay increases are being held to tough cash limits. This is already apparent. In the last, 1979/80, pay round, settlements were well below the generality of settlements in the private sector and the level of inflation.

13. The Government has made it clear that public sector wage settlements in this round must be sharply lower than last time. Ministers have already referred to the need for public services pay rises to be in single figures. The Government will not finance more than the country can afford.

22 October 1980

CONFIDENTIAL

CS

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

GTN 213

Tim Lankester Esq
Private Secretary
10 Downing Street
London SW1

27 October 1980

Dear Tim,

E COMMITTEE - 28 OCTOBER

As requested I am circulating a copy of my Secretary of State's minute to the Prime Minister to the Private Secretaries of all members of E Committee and Sir Robert Armstrong.

Yours sincerely

ANDREW HARDMAN
Private Secretary

SECRET & PERSONAL Econ Pol Strategy

Your Ref

Mr Lankester

with compliments

J B UNWIN

Treasury Chambers
Parliament Street
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Spare 2

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Anthony Rawlinson
Mr Ryrie
Mr Middleton
Mr Cassell
Mr Evans
Mrs Stamler
Mr Folger
Mr Ridley
Mr Bridgeman
Mr Battishill

R MW

ECONOMIC PROSPECT AND IMPLICATIONS FOR POLICY:
SMALL GROUP MEETING ON 21 OCTOBER

I thought that you would find it useful to have at hand for your own purposes at tomorrow's meeting a rough guide to the arithmetic emerging from current papers on the forecast and other issues.

2. I therefore attach a table which I have compiled after some discussion with Messrs Cassell, Odling-Smee and Evans. I must stress that the figures are very approximate (particularly given the uncertainties on the public expenditure side, not least on nationalised industries, and the fact that the prospects on the revenue side, including most importantly PPT, are still far from clear) and I should not want them to be pressed too far. But I think the table will help to illustrate the context (as seen now - there are bound to be changes before the Budget) in which the public expenditure proposals need to be considered.

3. Some very broad and tentative conclusions that I draw are as follows. If the Chief Secretary's expenditure proposals were delivered (thus validating the PSBR in the forecast), there is a prospect of a modest fall in interest rates next year. If, further, extra net revenue is raised by one or more of the measures at line (5) in the table, then that prospect is likely to be enhanced. But there must be considerable doubt as to whether the public expenditure position can be restored as suggested. This means that at least some of the extra revenue will have to be raised simply to offset an expenditure excess (if the prospect for interest rates is not to be correspondingly worsened). It is difficult to see where further net revenue could be raised except by increased tax on persons (eg abatement of revalorisation in addition to the NIC (employees) increase).

4. Again, I stress that this is very rough and ready and we shall need to refine as decisions are taken and the position on the various components becomes clearer.

J B UNWIN
20 October 1980

SECRET

PSBR 1981-82 £ Billion (current prices)

Item	Amount*	Comment
(1) PSBR in forecast	11.25	Assumes (a) White Paper totals less EC contributions restored by CST's proposals; (b) revalorisation of direct and indirect taxes.
(2) Nationalised Industries excess	+0.5	This is the further excess additional to that identified in July.
(3) Reduction in expenditure ex CST's proposals	-0.5	Arises because forecast as constructed shows excess over CST's ceiling (as result of extra NI benefit payments revealed by forecast).
(4) PSBR as sum of (1)+(2)+(3)	11.25	ie back to forecast starting point on assumption that all CST's proposals are delivered.
(5) Possible major revenue raisers in 1981-82:		
PRT 1.0		broad estimates - decisions still to be taken.
NIC (employees) 0.5		
VAT on imports 0.5		
2.0	-2.0	
(6) Possible major revenue reduction in 1981-82 stock relief	+0.5	broad estimate - could be smaller.
(7) PSBR as sum of (4)+(5)+(6)	9.75	Equivalent to 3¾% to 4% of GDP compared with illustrative 3% in MTFS.

* (+ denotes addition to PSBR; - denotes reduction)

Econ Pol

CHANCELLOR OF THE EXCHEQUER

MT

A SUMMARY AND ASSESSMENT OF THE LATEST NATIONAL INCOME FORECAST BY MR T BURNS

1. The forecasters have now completed their autumn assessment. The main conclusions are:

i) Output is expected to fall by 2½-3% in 1980 and perhaps by slightly less in 1981. The quarterly profile suggests that output could stop falling in the autumn of 1981 but recovery may be slow.

ii) After a sharp fall to 14% in the early months of 1981 the annual inflation rate will not decline much during 1981 and decline only modestly in 1982.

iii) The PSBR forecast now centres on £10¾ billion in 1980-81 and £11¼ billion in 1981-82.

iv) Bringing the growth of money supply back within the MTFS will be difficult and probably necessitate continuing high interest rates.

I am in broad agreement with the picture emerging from the forecast although I expect the inflation rate to decline faster in the early part of 1981 (the current momentum to lower inflation seems very strong), and expect to see an earlier and more pronounced upturn during next year than in the main forecast. But a further difficult year for output seems certain; it will be difficult to meet the monetary profile in the MTFS for 1981-2 as there will be continuing pressure for monetary expansion; and there is considerable scope for setbacks in the movement to lower inflation.

The current state of the economy

2. As is often the case, much of the forecasting exercise has been concerned with an interpretation of the current state of the economy in the light of recent events; particularly the problem of reconciling the recent combination of apparently rapid monetary growth to rising real interest rates, an increasing fiscal deficit, a high exchange rate and a severe drop in output.

The world economy

3. We are clearly in a period of recession for the industrialised countries. Under the impact of the large oil price increase in 1979 and the early part of 1980 world inflation accelerated and output began to decline from the first quarter of 1980. This decline is likely to continue until the end of this year and 1981 could be a year of relatively slow recovery. World industrial output may fall by around 1% this year and 1981 could show scarcely any increase if we take the year as a whole. The fall in world output has brought some weakening of oil prices and commodity prices in general. Inflation has begun to be reduced but only limited further reductions seem in prospect for 1981.

Demand and output in the UK

4. We expect UK output to fall both in 1980 and 1981; the forecast is for a fall in GDP of 2¼% in 1980 (close to the FSBR forecast) and 2½% in 1981. The quarterly profile suggests that output will fall until the autumn of 1981 after which there could be some modest recovery. This could result in the level of unemployment (narrow definition) being 2.5m by the end of 1981. I expect to see an earlier and more pronounced upturn during next year but do not dissent from the view that output in 1981 will be markedly down on the 1980 level. Recent monetary, fiscal and inflation developments suggest that, apart from the exchange rate and interest rates, the stance of policy has moved

from being very restrictive during last Winter to being much less restrictive since Spring; money supply growth has been well in excess of the rate of inflation and the PSBR has been running at an annual rate of maybe £15b. This could suggest some temporary recovery or stabilisation of domestic demand over the coming months but if money supply is to be brought back to the MTFS the real money supply must contract again. A major uncertainty for output continues to be the effect of the major loss of cost competitiveness due to the rising exchange rate and relatively rapid growth in labour costs. So far this year export volumes have held up well but we now face a major contraction. The effect of the loss of competitiveness is expected to have major effects in 1981 and 1982 which will reduce the extent to which the UK is likely to share in the benefits of any upturn in world output. Hence the profile of only a shallow recovery from mid-1981 after the previous sharp fall in output. The forecast shows the level of output in 1982 to be about the same as in 1981. In recent months considerable effort has been devoted in the Treasury to investigating the effects of competitiveness changes and the results of this work are implicit in the forecast. But, even if the competitive effects are smaller than implicit in the forecast, the world outlook suggests there will still be a significant fall in output in 1981 - say $1\frac{1}{2}$ to 2% - and it is very likely that output in 1982 will still be lower than in 1980. The fall in manufacturing output will be more severe; this is the normal pattern in recession and manufacturers are particularly affected by the loss of competitiveness.

Reactions of the company sector to severe financial pressure

5. The decline in output so far this year has been the result of a major reduction in stocks; some important components of demand - consumer spending, public authorities' current spending and exports - have been running at a higher level than last year. This represents some change of emphasis from the FSBR forecast where deteriorating net trade was

expected to contribute to the fall in output. The major inventory liquidation is clearly associated with the liquidity problems faced by the company sector. Earlier this year total income of the economy was rising at about 20% per annum. At the same time policy was aimed at reducing monetary growth to 7-11% with the intention of reducing the growth of total nominal income - and in turn inflation - towards this figure. Although monetary growth has exceeded the target some progress has been made in reducing the underlying growth of total incomes - albeit for the moment largely at the expense of output. The exchange rate and the pressure of demand have been crucial in this process. However, the reduced growth of incomes has been at the expense of the non-oil company sector; and particularly the trading sector. Personal disposable income has continued to rise at 20% per annum while company disposable income has probably been falling in current prices. In an effort to reduce borrowing the company sector has cut its stock levels and laid off many employees. The signs are that more is to come; company income continues to be under pressure and the stock/output ratio for manufacturing industry is above normal. Moreover expectations of future demand are weak, judging from recent CBI surveys.

6. Some of the reduction in company income has been due to the correction of anomalies of one kind or another or special events. The collapse of incomes policy and associated Clegg awards have raised local authority rates; the return to economic pricing in nationalised industries has also raised company overheads; the switch of taxes between direct and indirect, probably (irrationally) increased wage demands and settlements. High interest rates have been a further burden. At the same time the high exchange rate, partly due to higher oil prices, has prevented many of these costs being passed on, while at the same time increasing the purchasing power of the personal sector.

The balance between the personal and company sectors

7. The outlook for 1981 and beyond partly depends upon redressing some of this imbalance. It is particularly

important that some restoration of company disposable income takes place and in the absence of a sharp fall in the exchange rate or fiscal assistance this requires a reduction in real gross earnings. The forecast is based upon an average growth of earnings over the next pay round of 11½%; manufacturing earnings growth is expected to be restrained by market pressures to around 10% and public services pay (on the assumption given to the forecasters) by cash limits to around 9%. But given the pressure upon prices from low domestic demand and a high exchange rate this outcome would not be sufficient to provide much improvement in real company income. Under present circumstances it will be difficult to obtain a significantly better outcome on pay; and there is a real risk of doing less well. The present forecast implies a significant reduction in real pay over the next wage round and a steep deceleration from this year's level of settlements. But this will leave the company sector facing continuing pressure upon margins; it will imply no real improvement in cost competitiveness unless sterling falls, because average earnings in other industrial countries are likely to rise more slowly than in the UK.

Inflation

8. In recent months inflation has been much lower than might be expected on the basis of historic costs; by the end of the year it looks as though retail prices may be up to 3% less than suggested by the usual relationship. The forecasters put this down to the competitive pressures on prices from the efforts of producers to cut stocks and to try and match the prices of importers. The main forecast assumes that firms will continue to be unable to pass on into prices the full increases in costs but after a sharp fall in the inflation rate in the early months of 1981 to 14% little progress is expected for the rest of the year with the rate down to a little over 13% by the fourth quarter. Recent money supply figures provide no reason to expect any further fall; average growth of money supply over the past three years has been 15½%.

The view of some PCC members (including myself) is that in the short run we will do better than this; in recent months the underlying inflation rate has been below this (even allowing for the tendency for price increases to be lower in the second half of the year than the first half) and the indications are that this momentum will be carried forward into next year. The high exchange rate could mean that in the immediate future inflation continues to be below the rate we might expect looking at costs or money supply alone. In turn this could result in lower pay settlements. But the pressure upon profit margins may not continue and in the absence of a major deceleration in costs and monetary growth it will be difficult to sustain the improvement in inflation unless the exchange rate continues to rise to even more difficult levels.

The exchange rate

9. In the forecast the exchange rate is expected to be broadly stable for the rest of this year and only decline moderately in 1981. We need to show even greater modesty than usual in this respect as the exchange rate continues to confound all the forecasters. We can identify some of the major factors that have been contributing to sterling's strength; the oil price rise, increased OPEC funds, high interest rates. But this is clearly not exhaustive and the knowledge of these factors probably would not have led us to predict the current rate. Some of the pressure may subside as the real oil price stabilises and the flow of OPEC funds is reduced as they import more. But the continuing need to keep interest rates high and the determination to keep to the MTFS will exert pressure in the opposite direction. As already mentioned the effect upon competitiveness is substantial; our measure of relative unit labour costs is now 50% higher than it was in 1978. The extent and speed by which the real exchange rate has risen (that is the nominal exchange rate corrected for relative inflation rates) is without precedent. The size of the rise in the exchange rate was neither expected nor intended; it is certainly not a necessary part of Government strategy

that the rate should rise so far, though it has undoubtedly contributed to the reduction in the inflation rate this year. It would ease the process of adjustment considerably if the exchange rate was 10% lower. But it is also clear that there is little that can be done to achieve this without damaging the monetary strategy. It is therefore important to use whatever pressure is available to bring pay and prices in line with the exchange rate and attempt to reduce the real exchange rate by this route. This will inevitably be very difficult as pay and prices are adjusting only slowly to the high exchange rate. The Government has (rightly) been exhorting industry and unions to bear in mind the exchange rate when determining pay and prices; industry can legitimately exhort the Government to do likewise. The major nationalised industry prices and local authority rates are among the items showing least response to the high level of sterling, in part because the public sector is little involved in international trade.

The PSBR

10. The forecast PSBR for 1980-81 is now put at £10¾b although a realistic margin of error is still £2 billion; of this around £8.0b has occurred in the first half of the financial year. This represents an upward adjustment of over £2b compared to the FSBR forecast; the major overruns are for local authorities and public corporations and there is a shortfall of expenditure taxes. The main counterpart in the other sectors is a £13b private sector surplus (a £16b personal sector surplus offset by a £3b company sector deficit).

11. For 1981-82 the forecast is a PSBR of £11b; the forecasters stress the very large standard error involved. The assumptions behind the forecast are important; full inflation adjustment of taxes in the Budget; public sector pay limits of 9%; the maintenance of the volume plans in the recent White Paper modified by savings in EC contributions and additional Civil Service manpower cuts. The PCC discussion pointed out that this would not be easy to achieve and the PSBR could be

significantly higher. The 9% earnings assumption for public services' pay could be regarded as optimistic in relation to about 12% forecast for other sectors' earnings; the assumption that the Chief Secretary's July proposals will be achieved in full now look optimistic; nationalised industries' borrowing could be higher as the forecast heavily discounts recent estimates of the bids for external financing (in the light of experience). The main counterpart is a £12b private sector surplus (a £14b personal sector surplus offset by a £2b company sector deficit).

The monetary targets

12. Against this background the monetary target will continue to present difficulties. Recent performance has been particularly disappointing. It is not enough to argue that the target was too tight in relation to the underlying inflation rate: the outcome for monetary growth in the first half of the year has been clearly in excess of the inflation rate. The high PSBR in the first half of the year has almost certainly contributed a great deal. It is also likely that the large corporate sector borrowing requirement has involved heavy bank lending. The forecast has been prepared on the assumption that the underlying growth for £M3 will be 12% between February 1980 and April 1981 plus or minus 2%. This might provide an adequate base to re-affirm the monetary strategy and would imply a substantial correction of recent excesses. But this is likely to involve the maintenance of existing interest rates, substantial sales of National Savings and some slowing down in bank lending. A potentially serious problem is the strain on the balance sheets of banks if private sector lending continues to grow faster than the money supply. This may lead banks to bid public sector debt away from the private sector - thus increasing the money supply. This can only be offset by keeping short rates at much the present level.

Conclusion

13. The underlying situation therefore remains extremely difficult.

i) An attempt to get within the upper limit of the monetary target and back to the MTFS on the present PSBR forecast will imply a continuation of high short-term interest rates. Some correction to the PSBR in 1981-82 may be necessary to deliver the monetary target in the MTFS.

ii) Attempts to keep to the monetary policy may mean a continuation of a high exchange rate although the range of error is enormous.

iii) The level of output in the economy is likely to continue to decline into next year. A substantial part of this problem is the high exchange rate and the major disequilibrium between the personal and company sectors.

iv) The inflation rate and earnings outlook are much improved but the cost and monetary background gives little confidence that a major reduction of inflation below the central forecast can be sustained next year.

v) The private sector is making considerable (if belated) efforts to adjust to the high exchange rate. The public sector continues to be substantially out of step.

vi) If a successful shift to a 6-10% monetary target in 1981-82 is to be achieved and maintained this means focusing as many items of income and expenditure as possible towards the target. The present range where public current spending is rising at 20-25% and company income is falling is severely damaging to efforts to impose a strict monetary policy.

TB

T BURNS

9 October 1980

TABLE 1

SUMMARY OF FORECASTS

			Central forecast
PSBR	1979-80		10
£bn	1980-81		10¾
	1981-82		11¼
	1982-83		9½
Interest rate	1979	Q4	15¾
(a)	1980	"	15¾
198	1981	"	15½
	1982	"	14½
Exchange rate	1979	Q4	68¾
(b)	1980	"	75½
	1981	"	74½
	1982	"	71½
Inflation	1979	Q4	17¼
% changes in the RPI	1980	"	16¼
	1981	"	13¼
	1982	"	11¼
GDP growth	1979		1¾
% by volume	1980		-2¾
	1981		-2½
	1982		-
Company financial balance, £bn	1979		-3½
(c)	1980		-2½
	1981		-2½
	1982		-1
Unemployment rate	1979	Q4	5¼
%	1980	"	7¾
(d)	1981	"	10¼
	1982	"	11½

Notes: (a) The interest rate is the 3 month interbank rate.

(b) Exchange rate is the effective rate based on 1971 Q4 = 100.

(c) Company financial balance refers to the financial surplus of Industrial and Commercial companies.

(d) Unemployment is given excluding school-leavers seasonally adjusted as a percent of the labour force.

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Econ Pol.

SIR ROBERT ARMSTRONG
MR IBBS
MR WHITMORE (NO. 10)

cc Mr Penrice (Employment)
Mr Lane
Mr Forecast
Mr Ramprakash

REAL INCOMES

There is much talk and comment in the press about declining standards of living. The attached note about the numbers of people who are suffering big falls in their real disposable income may provide some useful background.

John Boreham

JOHN BOREHAM

9 October 1980

REAL INCOMES

1. The realincomes of people in regular employment are still rising on average, but there are always some groups whose real incomes are falling, either because of predictable events like normal retirement or because of economic effects. This note concentrates on some of these groups.

2. About 4 million people will be on the unemployment register at some time during 1980, nearly all of them having suffered a loss of real income.

3. Something like 2 million people can expect to experience short-time working or loss of overtime during 1980, involving a loss of real income while the spell lasts, with unemployment sometimes following.

The unemployed

4. About 4 million people - about two-thirds of them men - will probably experience one or more spells of registered unemployment during 1980. Though the total is not much more than in 1979, people are staying longer on the register or having more frequent spells of unemployment.

5. How severe the loss of income is as a result of loss of work depends on the level of earnings before becoming unemployed, on duration of unemployment, on benefit entitlement and on the number of children in the family.

6. For example, a single householder newly receiving unemployment benefit with earnings related supplement might suffer a cut of about 40 per cent in his net income if he had been earning £50 a week and about 60 per cent if he had been earning £120 a week. For a married man with two children the corresponding losses are about 20 per cent and 40 per cent.

7. The initial blow may be softened by special payments on leaving work (eg holiday pay, tax rebate and redundancy payment; a substantial proportion of the men coming on to the employment register receive some such payment.) However, a long spell of unemployment can bring further reductions in income. After 6 months earnings-related supplement (which is being phased out) ceases and after one year unemployment benefit is generally replaced by supplementary benefit. Of men currently unemployed, about 70 per cent have been on the register for over 8 weeks, about 40 per cent for over 6 months and about 25 per cent for over a year.

8. Long-term unemployment among older people will include a certain amount of voluntary early retirement, which may attract certain compensations. There are about 140 thousand unemployed men aged 60 and over; many have occupational pensions but these are commonly small.

Short-time working and loss of overtime

9. In July this year, there were about 450 thousand fewer manufacturing workers earning overtime than in July 1979 and about 200 thousand more on short time; (these groups overlap with each other and with the unemployed over the year). As many as 2 million different people could be affected by loss of overtime and by short-time in 1980. The initial loss of earnings in such cases is typically at least 25 per cent of gross wages.

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9 October 1980

Econ Pol

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ECONOMIC PROGRESS REPORT, OCTOBER ISSUE

The public sector borrowing requirement (PSBR) is an important indicator of how government policies are affecting the rest of the economy and in particular financial markets and the money supply. As part of its strategy to reduce inflation and monetary growth, the Government is planning for a substantial reduction over the medium-term in the PSBR as a percentage of the gross domestic product.

The leading article in the October issue of 'Economic Progress Report' describes the PSBR, shows how it has grown and how its composition and financing have changed since 1963, and describes its relationship to the money supply. It is based on an article recently published in 'Economic Trends' by the Central Statistical Office.

A short feature on page 3 explains why the PSBR in the current financial year is more than usually 'front-end loaded' - ie. it is being concentrated in the early part of the year.

Other material in this issue includes Developments in economic policy, a centre-page feature listing Government economic measures in the period March to September 1980 (pages 4 and 5), and the Treasury's latest Monthly economic assessment (pages 7 and 8).

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Economic Progress Report

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Public sector borrowing requirement

The public sector borrowing requirement (PSBR) is an important indicator of how government policies are affecting the rest of the economy and in particular financial markets and the money supply. As part of its strategy to reduce inflation and monetary growth, the Government is planning for a substantial reduction over the medium-term in the PSBR as a percentage of the gross domestic product.

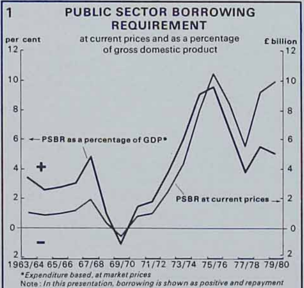
This article first describes the PSBR, then shows how it has grown and how its composition and financing have changed since 1963, and finally describes its relationship to the money supply. It is based on an article recently published by the Central Statistical Office*.

Public sector borrowing

The PSBR indicates the extent to which the public sector borrows from other sectors of the economy and overseas to finance the balance of expenditure and receipts arising from its various activities. The public sector comprises central government, local authorities and public corporations. The borrowing requirement of the whole public sector is important because government financial control extends over the whole sector, both through the public expenditure programmes and, on the financing side, through the central government's borrowing to meet not only its own needs but also a large part of those of the rest of the public sector. In return for access to funds through the central government, the rest of the public sector makes any temporary surpluses available to reduce the sector's overall borrowing requirement by investing them in public sector debt rather than in other assets. The PSBR is not affected by any switching by local authorities and public corporations between borrowing from central government and from the market, for example, when borrowing in foreign currency from banks or overseas has been encouraged by central government for balance of payments purposes through the exchange cover scheme. The more limited central government borrowing requirement (CGBR) is also an important figure for the Treasury and the Bank of England, since the central government borrows in somewhat different markets from local authorities and public corporations, and their borrowing does not have the same impact on the banking system as that of the central government.

The PSBR is one of several balances struck in the national accounting system. For the public sector, as for other sectors, national accounts classify transactions into current, capital and financial accounts. Table 1 sets out a summary current, capital and financial account for the public sector in 1979-80 and shows the points at which the main balances are struck, with the borrowing requirement at an intermediate stage in the financial account. Items above the borrowing requirement line

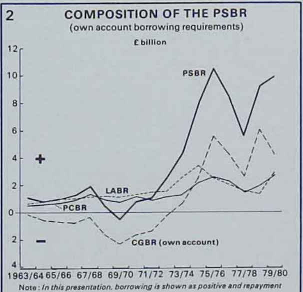
*See 'Measuring the public sector borrowing requirement' in *Economic Trends*, August 1980, which gives a detailed explanation of how the PSBR and its sub-sector components are compiled and published.



1 PUBLIC SECTOR BORROWING REQUIREMENT at current prices and as a percentage of gross domestic product

*Expenditure based, at market prices

Note: *In this presentation, borrowing is shown as positive and repayment as negative*



2 COMPOSITION OF THE PSBR (own account borrowing requirements)

Note: *In this presentation, borrowing is shown as positive and repayment as negative*

Table 1

COMPONENTS OF THE PUBLIC SECTOR: OUTLINE CURRENT, CAPITAL AND FINANCIAL ACCOUNTS 1979/80[1,2]

£ million

	General government				
	Central government	Local authorities	Total	Public corporations	Public sector
Current account					
Current saving	–398	1,213	815	4,031	4,846
Capital account					
Net capital transfers	–890	11	–879	568	–311
Gross domestic fixed capital formation	–1,537	–3,738	–5,275	–5,755	–11,030
Increase in book value of stocks and work in progress	–130	–	–130	–596	–726
Net acquisition of financial assets	–2,955	–2,514	–5,469	–1,752	–7,221
Financial accounts					
Lending to the private sector	24	–413	–389	90	–299
Purchases of company securities	310	–	310	–371	–61
Lending overseas	357	–	357	–101	256
Net trade credit	–	–	–	749	749
Receipts from unfunded pension schemes	247	–	247	–	247
Other identified financial assets	776	22	798	–633	165
Accruals adjustment	–2,314	157	–2,157	155	–2,002
Unidentified items	–705	–195	–900	–898	–1,798
Borrowing requirement (on own account)	**–4,260**	**–2,943**	**–7,203**	**–2,761**	**–9,964**
Central government direct lending to:					
Local authorities	–817	817	–	–	–
Public corporations	–3,151	–	–3,151	3,151	–
Other transactions in:					
Central government debt	8,228[3]	–10	8,218	–98	8,120
Local authority debt	–	2,122	2,122	130	2,252
Public corporation debt	–	14	14	–422	–408

[1] Consistent with *Financial Statistics*, July 1980.
[2] *Sign convention:* In this presentation, inflows are treated as positive, outflows as negative. Over the whole account, total inflow equals total outflow. The balances (net acquisition of financial assets and own account borrowing requirement) are struck by adding downwards. They therefore equal the total of the remaining inflows and outflows below them, but with opposite sign.
[3] The CGBR, i.e. the central government's borrowing to finance its own account borrowing requirement (–4,260) and also its on-lending to local authorities and public corporations (–817 and –3,151).

(approaching it from the current and capital account) are regarded as determining the size of the borrowing requirement, and items below as financing it, accommodating to its otherwise determined size.

The borrowing requirements shown in Table 1 are those *on own account*. For local authorities and public corporations these are indeed their borrowing requirements (LABR and PCBR respectively) but the CGBR and the general government (ie central government *plus* local authorities) borrowing requirement (GGBR) are in fact defined as including borrowing to finance direct on-lending to other parts of the public sector. The GGBR thus includes direct on-lending to public corporations and the CGBR includes direct on-lending to local authorities and public corporations. For local authorities and public corporations, the totals of the items below the borrowing requirement line other than their direct borrowing from central government are termed their *contributions* to the PSBR. There are therefore two ways of looking at the components of the consolidated PSBR and these are shown in Table 2.

Changes in the PSBR since 1963

The charts show the growth of the PSBR and changes in its composition and sources of finance since 1963, the earliest year for which data are available on current definitions.

Chart 1 compares the PSBR at current prices with the PSBR as a percentage of gross domestic product (GDP). In money terms the PSBR fluctuated relatively little from 1963-64 to 1971-72 (though it was negative, ie a net repayment, in 1969-70) but then rose sharply until 1975-76; it fluctuated after that but remained higher than at any time in the previous ten years. The PSBR as a percentage of GDP is in many ways a more useful measure of the changes over time, not least because it makes some allowance for inflation. It fluctuated rather more widely than the PSBR in money terms in the earlier years, and rather less in the later years, but it still showed a pronounced rise from 1971-72 to 1975-76, when it reached nearly 10 per cent of GDP; and although it fell after 1975-76, it remained generally above the levels of before 1972-73.

Table 2

COMPONENTS OF THE PSBR, 1979/80

More usually	£ million	*Alternatively*	£ million
CGBR	8,228	CG own account borrowing requirement	4,260
LA contribution	2,126	LABR	2,943
GGBR	10,354		
PC contribution	–390	PCBR	2,761
PSBR	9,964	PSBR	9,964

THE UNEVEN PATH OF THE PSBR

The forecast of the public sector borrowing requirement (PSBR) for the current financial year, published in the *Financial Statement and Budget Report* at the time of the Budget on 26 March, was £8½ billion.

The PSBR for the April-June quarter was £4.8 billion. This first quarter figure is, however, no guide to the likely outcome for the financial year as a whole. There are a number of irregular factors that are particularly important in the current financial year which result in borrowing being more than usually 'front-end loaded' – ie it is being concentrated in the early part of the year. These irregular factors include:

(i) the change in timing of receipts of petroleum revenue tax. This tax is now payable in September and March. Over £1 billion was received on 1 September and the effect of this will be reflected in the PSBR figures for the second quarter of the financial year.

(ii) Defence expenditure was unusually high in the first quarter and is now being reined back.

(iii) Most of the receipts from the special sales of assets are expected towards the end of the financial year.

(iv) Refunds arising from the 30 May agreement on the UK contribution to the European Community Budget will also occur towards the end of the financial year.

Some of these and other special factors also made last year's PSBR 'front-end loaded'. The high PSBR so far is similar to last year's pattern, when the PSBR was high in the first three quarters of the financial year and was substantially negative in the final quarter. The table below shows the quarterly figures of the PSBR and its components during the last two financial years and in the first quarter of the current year.

PUBLIC SECTOR BORROWING*

£ million

	Central government (own account)	Local authorities	Public corporations	Total public sector
Quarters				
1978 2nd qtr	2,066	83	68	2,217
3rd qtr	1,567	221	509	2,297
4th qtr	2,419	86	713	3,218
1979 1st qtr	–86	900	651	1,465
2nd qtr	2,684	270	391	3,345
3rd qtr	1,845	645	1,335	3,825
4th qtr	2,117	472	1,340	3,929
1980 1st qtr	–2,416	1,556	–339	–1,199
2nd qtr	3,275	600	1,035	4,910
Financial years				
1978-79	5,966	1,290	1,941	9,197
1979-80	4,230	2,943	2,727	9,990

*Not seasonally adjusted, consistent with *Financial Statistics*, September 1980.

Chart 2 shows that, compared with central government own account borrowing, the LABR and the PCBR have been relatively steady since 1963-64 though both fluctuated more after 1972-73 than in the earlier years. Central government own-account borrowing, in contrast, varied widely over the whole period. It was negative from 1963-64 to 1972-73 and positive since then, with fluctuations superimposed on this underlying shift. The PSBR has generally varied in step with the large changes in the central government component.

The PSBR is financed in three main ways; by sales of debt to the public outside the banking system (for example, gilts, national savings, local authority stocks and bonds); by external transactions (ie transactions with residents of other countries) which include not only government borrowing but also changes in the official reserves; and by borrowing from the banking system. Chart 3 shows changes in the sources of finance for the PSBR by lending sector. The main features are the increasing importance from about 1970-71 of borrowing from the non-bank private sector (mainly 'other financial institutions' and persons) and the pronounced net repayments to overseas in 1969-70 to 1971-72 and again in 1977-78, when there were sharp increases in the official reserves.

continued on page 6

READERS' ENQUIRIES

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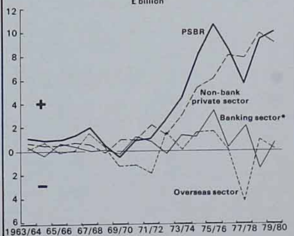
3 SOURCES OF FINANCE FOR THE PSBR

£ billion



*Includes foreign currency borrowing from banks
Note: *In this presentation, both borrowing and its financing are shown as positive, repayment and its counterparts as negative*

DEVELOPMENTS IN ECONOMIC POLICY

Date	INDUSTRY	EMPLOYMENT, INCOMES, PRICES	HOME FINANCE	OVERSEAS FINANCE
3.3.80		*Youth Opportunities Programme* expansion for 80-81 announced by Manpower Services Commission.		
20.3.80			Green Paper on *Monetary Control* published.	
26.3.80 Budget	Scheme to allow income tax relief on certain losses on equity investments in small companies; ending of certain close company restrictions; extension of relief for interest on borrowings to invest in close companies; reduction in 'small companies' rate of corporation tax to 40% and 100% capital allowances for construction of small industrial buildings. *Enterprise Zones* scheme announced. *Stock relief*: one year deferral of certain recovery charges. Changes in allowances for expenditure on certain kinds of *leasing*. *PRT* raised from 60 to 70%, and payments *advanced*.	*Pensions* to be raised in November to £43.45 (married), £27.15 (single). £10 *Christmas bonus* for pensioners and others. *Family Income Supplement* to be improved. *Short-term benefits* and *invalidity benefit* to be raised in November by 5% less than forecast prices rise. *Earnings Related Supplement* to be reduced from January 81 and abolished January 82. *Child Benefit* to be raised in November to £4.75, lone parent's premium to £3. *Mobility allowance* to be raised to £14.50 in November. *Supplementary benefit to strikers' families* to be reduced, and taxed in due course.	Medium-term *financial strategy* published, charting reduction in monetary growth to around 6 per cent by 83-84. *Monetary policy*: target for sterling M3 growth of 7-11 per cent (annual rate) for mid-February 80 to mid-April 81. *Income Tax*: increased personal allowances, abolition of 25% lower rate, raising of higher rate thresholds, indexation of higher rate bands and investment income surcharge from 81-82, reduction of relief on insurance premiums to 15% from April 81. *CTT*: threshold doubled to £50,000. *Indirect taxes*: excise duties raised.	
31.3.80			*National Heritage Act* received Royal Assent.	
1.4.80		*National Insurance Contributions* increased. *Prescription charge* rose to 70p.	National Debt Office and Public Works Loan Board merged to form *National Investment and Loans Office*.	
2.4.80		Green Paper *Income during Initial Sickness — a New Strategy*.		
3.4.80	*Competition Act* received Royal Assent.		*Education (No 2) Act* received Royal Assent.	
29.4.80				Ending of mandatory foreign currency financing of *export credit contracts* involving finance of £5m or more.
1.5.80	*British Aerospace Act* received Royal Assent.			
13.5.80			*Civil service staff cuts* to 630,000 by April 84 announced.	
14.5.80				Agreement on increases from 1 July in international minimum interest rates for officially-supported medium and long-term *export credits* (½% for poorer countries, ¾% for others).
23.5.80		*Social Security (No 1) Act* received Royal Assent.		
30.5.80				EC Foreign Affairs Council agreed on reduced *UK net contribution to EC Budget*. The Agricultural Council agreed on 5% *farm price* increases and new arrangements for *sheepmeat*.
13.6.80		*Local authorities* in England and Wales requested to review 80-81 budgets so as to cut real expenditure to 2% below 78-79 expenditure.		
18.6.80			End of *Supplementary Special Deposits Scheme* ('corset').	
19.6.80	Statement of plans for *gas-gathering pipeline* in North Sea.			
19.6.80	Measures announced to help *areas hit by steel industry cuts*.			
27.6.80				Agreement announced on *debt settlement with Zimbabwe*.
30.6.80	*Industry Act, Transport Act*, received Royal Assent.			
1.7.80	Announcement that Government to provide £42.5m to *Harland and Wolff* in 80-81, review structure and management policy, etc.			
3.7.80			*MLR* cut from 17% to 16%.	
7.7.80		PM announced salary increases (less than proposed in Top Salaries Review Board's report) for *senior public servants, ministers and MPs*.		
14.7.80	Announcement of intention to inject private capital into *British Rail subsidiaries*.			Announcement that *HMG $1.5bn Eurodollar loan* to be prepaid during 1980.
16.7.80	*Post Office*: proposal to relax postal monopoly announced.			
17.7.80		Social Security (No 2) Act *received Royal Assent*.	Announcement of committee set up to review enforcement powers of *Inland Revenue* and *Customs*.	
21.7.80	*Post Office*: proposal to relax telecommunications monopoly announced.			
21.7.80	*Electricity supply*: Intention to end monopoly announced.			
21.7.80	Announcement of intention to legislate to allow introduction of private capital into *British Transport Docks Board*.			
23.7.80	*Oil depletion policy*: some production to be deferred from 80s.		Announcement of intention to reorganise *NHS* administration, including abolition of Area Health Authorities in England.	
29.7.80	Announcement of names of 7 *Enterprise Zones*; and £25m for Inmos micro-chip factory in South Wales.			
1.8.80		Employment Act received Royal Assent.	*Finance Act* received Royal Assent.	
4.8.80	Announcement of more flexible financial control of *nationalised industries*.	Announcement that *Clegg Comparability Commission* to be abolished, *Review Bodies* to be retained.		
7.8.80	*National Freight Corporation*: decision announced to incorporate as the National Freight Company on 1 October, as first step towards privatisation as soon as possible.		Announcement that *local authorities* in England and Wales expected to plan for volume of current expenditure in 81-82 2% below targets set for 80-81.	
8.8.80	*Coal Industry Act* received Royal Assent.	*Health Services Act* received Royal Assent.	*Housing Act* received Royal Assent.	
2.9.80				Announcement of final repayment on 1977 *IMF* standby.
9.9.80			*National Savings*: Announcement that new index-linked certificate to be issued to holders of 60 or over; limits on monthly payments on index-linked SAYE to be raised.	
18.9.80			Announcement that revised budgets of local authorities in England and Wales for 80-81 still 2.6% above level requested. Proposals to reduce grant by £200m in consequence.	

Table 3

PSBR, STERLING M3, AND THE BANKING SECTOR BALANCE SHEET

PSBR		Banking sector: net increase in: Total assets	Banking sector: net increase in: Total liabilities		Sterling M3
Sterling borrowing from banks	a	Sterling lending to public sector	Sterling deposits of UK residents	d	UK residents' sterling bank deposits
–	b	Sterling lending to non-bank private sector	Sterling deposits of overseas residents	e	–
–	b	Sterling lending to overseas residents	Foreign currency deposits	e	–
	c	Foreign currency lending:	Net non-deposit liabilities	e	
Foreign currency borrowing from banks	c	Public sector			–
–	c	Other			–
Borrowing from the non-bank private sector:					
Notes and coin					Increase in notes and coin in circulation
Other					–
Borrowing from overseas and other foreign currency borrowing					–
Total PSBR					Total increase in sterling M3

The PSBR's link with money supply

The relationship, in accounting terms, between the PSBR and sterling M3, the measure of the money supply to which the government's target relates, can be seen by arranging the balance sheet of the banking system and details of public sector financing as in Table 3†.

In Table 3 the balance-sheet relationship determines that:

$$a + b + c = d + e$$

In purely accounting terms, it can be seen from the table that public sector borrowing from banks (a) represents an increase in the banking sector's total assets which will in turn generally tend to be reflected in changes in UK residents' sterling bank deposits (d), the major component of sterling M3. This accounting relationship does not, however, carry any implications for economic behaviour. In particular, when the PSBR, or any other individual item in the relationship, changes this may well be accompanied by changes in other items so that the effect on the money supply is not one for one. For instance, an increase in the PSBR may be accompanied by an increase in private sector financial wealth leading possibly to more purchases of public sector debt by the non-banks and perhaps to lower bank lending to the private sector, and these will influence the net effect on sterling M3. The relationship between the PSBR and sterling M3 will also depend critically on the level and structure of interest rates and hence on the monetary policy being pursued.

†More detailed descriptions, including the accounting link with domestic credit expansion (DCE), are given in, for example, the article 'Monetary policy and the economy' in the July 1980 issue of *Economic Progress Report*, an article 'DCE and the money supply – a statistical note' in the March 1977 issue of the *Bank of England Quarterly Bulletin*, and the 1980 edition of *Financial Statistics Explanatory Handbook*.

National income

The 1980 edition of the annual 'Blue Book' – ***National Income and Expenditure*** **– was recently published by the Central Statistical Office (HMSO, price £10.50). It contains statistics of national income, expenditure and output for the years 1969 to 1979. In addition, the main summary tables go back to 1958 on a consistent basis.**

The *gross national product* (the total income of all UK residents) amounted to £164 billion in 1979, compared with £145 billion in 1978. The average per head of the population was about £2,930. *Gross domestic product at factor cost* (the total value of goods and services produced in the UK excluding taxes on expenditure) rose by 14 per cent between 1978 and 1979. After allowing for the effects of inflation, the real increase in GDP (at 1975 prices), shown by the average of the three measures (income, expenditure and output), was 1½ per cent, lower than the rise of 3 per cent in the previous year. Excluding North Sea oil and gas, the increase was only ½ per cent.

Total personal income (income from employment and self-employment, investment incomes and government grants) increased 17 per cent before tax between 1978 and 1979. As a result of the cuts in personal taxation in 1979, *personal disposable income* rose by rather more than this, by 18½ per cent. *Saving* in 1979 was 14 per cent of disposable income, about 2 per cent higher than the average of the previous three years.

After allowing for the effects of price changes, *real personal disposable income* rose by 6 per cent. This increase follows the even larger increase, of 8 per cent, recorded for the previous year. This is only the second case since 1945 of a rise of 14 per cent or more over two years, the previous occasion being between 1971 and 1973.

In 1979, total *consumers' expenditure* amounted to about £115 billion – £2,050 per head of the population. Over the ten-year period 1969-79, the share of expenditure on food, clothing and footwear and tobacco fell, while that on housing, alcoholic drink, buying and running motor vehicles all rose.

Profits of industrial and commercial companies, excluding North Sea oil companies and after deducting stock appreciation, showed little change in 1979, while income from employment rose 17 per cent. North Sea oil and gas companies doubled their profits, net of stock appreciation, between 1978 and 1979, and their share of industrial and commercial companies' profits rose from 12 per cent to 22 per cent.

Monthly Economic Assessment

Prepared by the Treasury on the basis of data available up to 26 September 1980*

- Recent months have seen smaller price increases, which have progressively lowered the year-on-year level of price inflation.
- The volume of exports continues to be flat. There was a surplus on visible trade in August for the third consecutive month.
- Output fell sharply in the second quarter. Unemployment continued to rise rapidly in September.
- Partly because of the unwinding of distortions caused by the 'corset', money supply has been growing above the target range.

Monetary developments

Money supply on the broad definition, sterling M3 (notes and coin in circulation plus UK residents' sterling bank deposits) increased by £1.8 billion (2.9 per cent) in the banking month of August. Like last month, this month's figures were distorted by the ending of the supplementary special deposit scheme (the 'corset'). This makes it difficult to assess the underlying rate of growth, but the best estimate at present is that in both the banking months of July and August it was 1-2 per cent.

The large central government borrowing requirement of just over £2 billion was a major contribution to the increase in the money supply. Net purchases of central government debt by the non-bank private sector, at about £1.2 billion, were also large and offset a substantial part of the borrowing requirement. Bank lending in sterling to the private sector in the banking month of August amounted to £860 million.

Extensions to index-linked National Savings schemes were announced on 9 September. These are intended to offset the declining contribution of National Savings to financing the PSBR over the last year and a half compared with the levels achieved in the previous two and a half years. The changes are expected to raise an additional £1½ billion towards financing the PSBR during the remainder of the financial year, and will ease the pressure on the gilt-edged market and hence on long-term interest rates.

Interest rates in the UK fell somewhat during September but remained broadly stable in the USA and Europe. The interest differential in favour of the UK thus remained substantial. The 3-month inter-bank rate has fallen about 1 per cent since the beginning of the month to around 15¾ per cent on 23 September, while the one-year rate fell slightly more over the same period to $13^7/_8$ per cent. The **gilts market** has been generally firm during September on continued expectations of a reduction in MLR, with yields falling about 1 per cent at the short end (5 years) and by around ½ per cent at the long end (20 years) by 23 September. A new stock (£1,300 million Exchequer 12 per cent 1998 'A') was announced on 12 September.

Gross domestic product

The output measure of **GDP**, usually considered to be the best indicator of short-term movements, fell by about 2 per cent between the first and second quarters of 1980, reflecting the widespread fall in private domestic demand.

On the expenditure measure, GDP showed a decline during the second quarter of 2½ per cent at constant market prices. Consumption was down in the second quarter, reflecting the pre-Budget boost to sales in the first quarter. Gross domestic fixed capital formation declined slightly, but within the aggregate figures public sector investment increased. Public expenditure on goods and services was broadly unchanged. The reduction in the level of stocks continued during the second quarter. During 1980 the volume of exports of goods (excluding erratic items) has been maintaining a broadly flat profile; but import volume (excluding erratic items) was down 4 per cent during the first half of 1980 compared with the second half of 1979.

Company sector

Industrial production fell by 2 per cent in the three months to July compared with the previous three months (February-April); manufacturing output fell by nearly 2½ per cent in the same period. Within manufacturing nearly all sectors have recorded falls in output, most notably chemicals (down by 8 per cent). Taking the first seven months of the year together, which to some extent eliminates the impact of industrial disputes in 1980, industrial production for this period was some 4 per cent, and manufacturing output some 5½ per cent, lower than the average level in 1979. Output of the construction industry fell by about 4½ per cent during the second quarter. Output of North Sea oil and gas so far during 1980 has remained at much the same level since the second quarter of 1979.

Employment in the index-of-production industries fell by 87,000 between June and July. The fall in employment has been concentrated in manufacturing industry. In the first seven months of 1980 manufacturing employment has declined by 4 per cent compared with the average for 1979. Productivity in manufacturing is thus holding up in the face of declining output, and indicates that firms are shedding labour rapidly in order to alleviate their financial pressures. This rapid fall is responsible for the sharp rise in unemployment.

The number of people in the UK registered as **unemployed** rose to 1,784,000 (excluding school-leavers) at the September count, a rise of 88,000 in the month. The average monthly increase in the third quarter was 83,000 compared with 41,000 in the second quarter. The number of **school-leavers†** registered as unemployed fell by 57,000 during the month. Notified unfilled vacancies were 113,000 in September, a fall of 8,000 since August.

Manufacturer's raw material costs have risen more slowly in recent months but labour costs have continued to rise rapidly. **Prices of materials and fuels†** purchased by manufacturing industry fell by ¼ per cent between July and August. The year-on-year increase in the index fell – for the fifth consecutive month – to 19 per cent in August. In the six months to August the index rose by 3¾ per cent at an annual rate, compared to an annual rate of more than 35 per cent over the previous six months. This recent rapid deceleration in costs of materials and fuels reflects the appreciation of sterling and the easing of commodity price pressures, especially on oil.

Prices for manufacturers' home sales† (wholesale prices) rose by only ½ per cent between July and August and the year-on-year increase in the index fell for the fourth consecutive month to 15¼ per cent. In the six months to August the annual rate of increase was 10 per cent. Since the beginning of this year wholesale prices have shown progressively smaller increases each month. In recent months there has almost certainly been a decline in profitability. To some extent this reflects manufacturers' attempts to maintain sales against strong competitive pressures.

Gross domestic fixed capital formation in total declined by 2 per cent in the second quarter. Within the total, the public sector element rose slightly (despite a reduction in public service and dwellings investment) because of a higher level of investment by public corporations.

Manufacturing investment was down 5 per cent in the second quarter whilst distribution and service investment was up by 3 per cent. The latter includes financial companies which lease some of the fixed assets that they own to manufacturing industry. Manufacturing, distribution and services capital formation in total remained unchanged during the second quarter, and fell by 1 per cent between the second half of 1979 and the first half of this year.

The fall in sales combined with financial pressures induced wholesalers and retailers to continue to reduce **stocks** in the second quarter. Manufacturers reduced stocks only slightly although the pattern so far

*Unless otherwise stated, all statistics quoted in this assessment are seasonally adjusted.

† Not seasonally adjusted.

this year has been distorted by the effects of the steel strike. In the first half of 1980 manufacturers, wholesalers and retailers in total reduced their stocks by £900 million (at 1975 prices), a sharp turnaround from the £350 million increase in stocks in the latter half of 1979. Even so, stock levels were still higher in relation to sales and production at the middle of the year than at the end of 1974, and indications from the CBI industrial trends survey are that stocks are still above desired levels.

Personal sector

Average earnings of employees in Great Britain are estimated provisionally to have risen by 18.8 per cent in the year to July 1980. However, this number was artificially depressed by the presence of large amounts of back pay in July 1979. The underlying increase in earnings in the year to July 1980 is estimated at 21½ per cent. Earnings are being depressed by reductions in overtime and widespread short-time working.

The tax and price index* (TPI) rose by 18.5 per cent over the same period. (In the year to August the TPI rose by 17.8 per cent.)

The earnings and TPI statistics indicate that the underlying level of real take-home pay for an individual paying the basic tax rate has increased by about 2 to 3 per cent in the year to July 1980.

Retail prices* rose by 0.2 per cent in August reflecting small price increases in most sectors and a substantial fall in the prices of seasonal foods. In the year to August the index rose by 16.3 per cent, compared with 16.9 per cent in July, and a peak annual rate of 21.9 per cent in May.

Consumers' expenditure in the second quarter fell by 2½ per cent from the high pre-Budget buying level of the first quarter. In the first half year as a whole, however, it was about 1½ per cent higher than in the latter half of 1979, and the savings ratio declined by about 1 percentage point to 14 per cent. The volume of retail sales fell by almost 2 per cent between the first and second quarters. The July and provisional August figures suggest that retail sales are about 1 per cent below the monthly average of the second quarter.

External trade and payments

The volume of **exports of goods** (excluding erratic items) in August confirms the broadly flat underlying monthly level so far this year. Exports of manufactures (excluding erratic items) have changed little, though this conceals some falls in exports of semi-manufactures, offset by a slightly more buoyant performance by some categories of finished goods. The flat volume of exports suggests that the benefit of a continuing increase in world trade has been offset by the effects of declining competitiveness. The volume of **imports of goods** (excluding erratic items) increased by 4 per cent during August but this represents a recovery from an erratically low July level. The volume of imports fell some 4 per cent between the second half of 1979 and the first half of 1980. This fall has been widely spread. There have been lower imports of fuels, and food, drink and tobacco imports have been lower, but have recently shown signs of recovery. Imports of basic materials are below their high level in the latter part of 1979, reflecting reductions in manufacturing output and stocks of materials. Imports of finished manufactures have also declined.

With the balance on **invisibles** in August projected to be £75 million, the **current account** was £138 million in surplus. The large favourable balances in July, on both oil and non-oil trade (mainly reflecting trade in erratic items) were reduced in August by around £100 million each. In the eight months to August the visible deficit was about £600 million. The current account is estimated to be in a small overall surplus so far this year after allowing for the surplus on invisible trade. This compares with the forecast published in the *Financial Statement and Budget Report* at the time of the March Budget of a £1½ billion current account deficit in the first half of 1980. The current account has benefitted not only from the favourable volume balance of imports and exports but also from improvements in the terms of trade. Export prices have risen by 2½ per cent over the three months to August, whilst import prices have declined by ½ per cent on account of sterling's strength and weakening commodity prices.

The sterling exchange rate* in the month to 26 September was broadly stable, showing a marginal decline of 0.3 per cent against the US dollar and of 0.1 per cent in effective terms. On 26 September it closed at £1 = $2.3945 and 76.1 effective (21 December 1971 = 100). Overseas investment in British gilts and holdings of sterling banking and money market liabilities increased by over £1½ billion* during the second quarter following an increase of £¾ billion* in the first quarter of 1980. At the end of August the UK's official reserves stood at $28.3 billion*, the same level as at the end of July.

†Not seasonally adjusted.

Economic indicators[1] (seasonally adjusted)

PUBLISHED MONTHLY (months or monthly averages)	Unit	1979	1979 3rd qtr	1979 4th qtr	1980 1st qtr	1980 2nd qtr	1980 June	1980 July	1980 Aug	
1. Industrial production	1975=100	112.6	112.6	112.4	110.4	106.6	107.1	106.4	–	1
2. Unemployment (excl. school-leavers)	000s	1,303.4	1,266.8	1,286.7	1,377.8	1,492.3	1,535.1	1,606.0	1,695.4[5]	2
3. " " "	% of all employees	5.4	5.2	5.3	5.7	6.2	6.4	6.6	7.0[5]	3
4. Retail sales (volume)[2]	1976=100	101.5	99.0	101.0	102.4	100.6	100.7	99.0	100.5	4
5. Exports f.o.b.[3]	£m	3,391	3,547	3,672	3,975	3,844	3,690	4,032	3,958	5
6. Imports f.o.b.[3]	£m	3,674	3,711	3,934	4,186	4,038	3,967	3,771	3,895	6
7. Balance of payments current balance	£m	−155	+2	−213	−54	−29	+80	+311	+75	7
8. £'s effective exchange rate (average for month)[4]	21.12.71=100	67.8	71.0	68.8	72.1	73.3	73.7	74.6	75.5	8
9. Official reserves[4] (end of period)	$m	22,719	22,751	22,719	26,963	28,172	28,172	28,272	28,291[6]	9
10. Money supply: Sterling M3 (end of period)	£m	55,750	54,180	55,750	56,860	58,720	58,720	61,670	63,480	10
11. Retail prices[4]	Jan 1974=100	223.5	231.3	237.6	248.8	263.2	265.7	267.9	268.5	11
12. Tax and price index[4]	Jan 1978=100	113.2	115.0	118.7	125.2	132.2	133.6	134.9	135.3	12
13. Average earnings (older series)[2]	Jan 1974=100	247.8	250.5	265.5	276.0	289.9	298.0	299.7	–	13
14. Average earnings (whole economy)[2]	Jan 1976=100	150.9	153.9	161.7	168.7	178.1	182.3	182.7	–	14

PUBLISHED QUARTERLY	Unit	1979	1979 1st qtr	1979 2nd qtr	1979 3rd qtr	1979 4th qtr	1980 1st qtr	1980 2nd qtr	
1. Output (gdp) at constant factor cost	1975=100	110.2	108.6	112.1	109.8	110.4	109.4	107.4	1
2. Manufacturing industry's fixed capital expenditure	£m 1975 prices	3,872	964	962	969	977	948	902	2
3. Consumers' expenditure	£m 1975 prices	70,816	17,406	18,242	17,417	17,751	18,072	17,634	3
4. Balance of payments, current balance	£m	−1,863	−965	−264	+5	−639	−162	−68	4
5. Balance of payments on invisible account	£m	+1,541	+637	+261	+497	+146	+470	+233	5

1. Many of the most recent figures are provisional and may be subject to revision. 2. Excluding Northern Ireland. 3. Balance-of-payments basis. 4. Not seasonally adjusted. 5. Figures for September were 1,783,500 (7.4 per cent of all employees). 6. Figure for September was $27,637 million.

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Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury
Great George Street
LONDON SW1P 3AG

7 October 1980

Dear Geoffrey

See Part 6

MINISTERIAL STEERING GROUP ON GOVERNMENT STRATEGY (MISC 14)

You wrote to Cabinet colleagues on 12 August seeking comments on proposals for further work by the Group.

I am generally happy with the 5 key areas for future work listed in Annex A of the note enclosed with your letter. Under the first heading, fiscal incentives, I have a particular interest in profit sharing and share owenership schemes.

I am very much involved in the second area, labour mobility, and look forward to seeing the CPRS report on options.

Under the heading of reducing burdens placed on industry by Government, the two references to health and safety were both embraced with the report of the CPRS which was taken by E(EA) on 31 July. Further work on the CPRS recommendations is being undertaken by the inter-departmental working party of officials under Patrick Mayhew's chairmanship, and it seems to me that these items might therefore be transferred to Annex D as being adequately in hand.

Under the heading of measures to help small firms I look forward to seeing the progress report from the Treasury working group.

I am very much concerned with the last heading, industry/training/education. I am about to circulate to E Committee the report by officials on options on industrial training, together with my own comments. MISC 14 will no doubt be kept in touch with progress.

I have no particular suggestions to put forward for other topics which might be examined by the Group. My own departmental responsibilities in particular seem adequately covered.

I have noted, and instructed my department to act on, the guidance in para 3 of the note attached to your letter concerning clear allocation of responsibility for progress on items of work for the group, questioning of "conventional" wisdome and drawing on outsiders' views and experience in appropriate cases.

I have also noted your point about the progress of work described in Annex D as being adequately in hand and have arranged for items where my department is in the lead to be kept under review accordingly.

I am sending copies of this letter to the Prime Minister, other Cabinet colleagues, Norman Fowler, Sir Robert Armstrong, Robin Ibbs and John Hoskyns.

Yours
Tom

Strategy

CF

pa –

4

Prime Minister

The final section of this note on the back page is worth reading – a good summary of our policy dilemma.

TL.

MT

Schroders
Perspective on the UK Economy

Autumn 1980

The Short Term Outlook

The UK recession is now well established; the output measure of GDP fell 2% between the first and second quarters of 1980 reflecting a decline in activity throughout the economy. A further decline is expected in the third quarter and the year-on-year figures will probably eventually reveal a decline in GDP during 1980 of approximately 3%. A glimmer of hope is however provided by the CSO's longer leading cyclical indicator which has been on an upward trend since last November. This suggests that the trough of the recession may occur early in 1981.
Despite the steadily worsening news from the real economy the authorities have so far taken no new policy initiatives. In fact there have been suggestions of a further tightening of fiscal policy through more public expenditure cuts or raised personal taxation. This cautious stance is partly accounted for by the recent behaviour of the broad money supply: during July and August alone £M3 rose by 8%. While much of this massive increase represents an adjustment by the banking system following the abolition of the 'corset' in June it nevertheless remains the case that underlying monetary growth since April on an annual basis has been nearer 20% than 10% and well in excess of the 7-11% target.

☐ The annual rate of inflation was down to 16.3% in August – 5.6% below the 21.9% peak recorded in May. A deceleration in commodity, wholesale and retail price inflation has been apparent since April. By mid-1981 the annual rate of retail price inflation may be as low as 10-12%. Further progress into single figures will require low pay settlements this winter and continued stability of sterling.

☐ The increase in average earnings during the 1979/80 pay round exceeded most expectations. During a period when manufacturing production declined by 7% average earnings in that sector rose by 17½%. Meanwhile comparability awards boosted pay increases in public administration and public utilities to 26% and 35½% respectively. There may now be a tendency for commentators to overestimate the amount by which average earnings will rise in the present round. The increase for the whole economy may be not much more than half the 22% rise recorded last time.

☐ The surge in underlying monetary growth during the summer was not unrelated to the very high level of public borrowing. The PSBR during the first half of the 1980/81 financial year was probably at least £7bn in relation to a target of £8.5bn for the whole year. A substantial overshoot is thus in sight despite the more favourable balance between receipts and expenditure expected later in the year.

☐ The speed with which MLR declines from now on will depend upon the authorities' assessment of the strength of the real economy. Stability of sterling which would facilitate a rapid decline in inflation and very low monetary growth – necessary to restore confidence in the Financial Strategy – both argue for the maintenance of relatively high rates. However the possible consequences for export volumes and private investment make such a policy very risky.

☐ The outlook for unemployment is bleak. In September the seasonally adjusted unemployment rate rose to 7.4% of the workforce or 1.8 million persons. Reduced domestic demand is not the only cause of reduced employment. An important structural change is also occurring – facilitated by the high exchange rate – whereby labour intensive manufacturing production is being replaced by North Sea oil output.

☐ The movement into current account surplus during the past four months reflects the severity of the domestic recession and the initial effects of a strengthening of the exchange rate. As the world recession starts to erode UK export markets – which grew strongly during the first half of the year – export volumes will decline sharply. A current account surplus in 1981 is thus by no means assured.

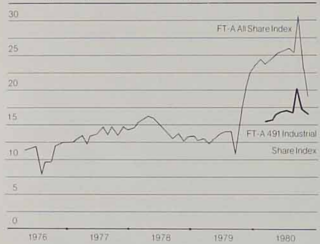
☐ Sterling at $2.40 and an effective exchange rate of 76 represent a decline in price competitiveness since 1976 of about 30%. For this reason alone, regardless of arguments about interest rate differentials, such a parity does not look sustainable except in the very short term.

Gross Total return

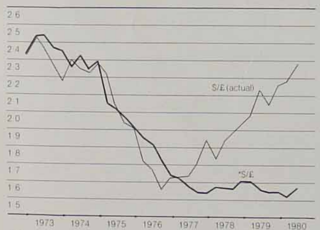
%	1977	1978	1979	1980H1	1980Q3
F.T. All Share Index	+48·0	+ 8·4	+10·5	+21·1	+9·4
F.T. Govt. Secs. over 15 years	+47·8	− 3·4	+ 4·5	+13·8	+6·2
Schroder Property Unit Trust	+16·4	+17·8	+25·2	+14·5	+3·0
S&P Composite Index*	−26·2	+ 6·6	−24·3	+ 2·4	+9·7
New Tokyo SE Index*	− 6·1	+55·9	−45·9	+6·6	+6·7

*through $ premium (discontinued on 23rd October, 1979).

Percentage change in dividend income year-on-year



The sharp rise in dividends following the relaxation of dividend controls has now started to subside and the year-on-year increase is expected to come back close to single figures in 1981. It is notable that income on the FT-A 491 Industrial Share Index which excludes oil and financial stocks has been advancing at a significantly slower rate than on the FT-A All Share Index.



*$/£ exchange rate adjusted to reflect differential wholesale price inflation in the UK and the US.

The chart shows how the price competitiveness of UK goods has deteriorated with respect to US goods. On this measure sterling is currently overvalued by about 30%. Such a development is due to the combination of several factors – principally North Sea oil and high UK interest rates. As the latter decline overvaluation of sterling should be reduced or at least stabilized.

Capital Market Report

Recent Market Movements

As the table indicates the third quarter of 1980 has seen a further widespread advance in market levels. The biggest gains have been seen in US equities, where tentative signs of economic recovery have restored confidence in spite of an upward movement once again in short term interest rates.

In the UK the prospect of a much lower rise in wage costs, lower interest rates and significant productivity gains, once the economy starts to recover, have more than compensated for a series of very depressed company results and continued pressure from the strong pound. The fixed interest market started the quarter more strongly than the UK equity market but the disarray caused by the sudden jump in the July money supply figures announced in early August saw a reaction taking long dated gilts back by just over 8%, from which level only a partial recovery took place.

Towards the end of the quarter the hostilities between Iraq and Iran have had an unsettling effect on most markets: the full impact while potentially significant can at this stage only be conjectured.

Property unit trust prices have tended to stabilise after a long period of relatively strong performance, although, in spite of the decline in the economy, prime property prices show no sign of falling.

Market Outlook

1980 has already seen a significant recovery in the UK equity market bringing it in real terms close to the top end of the trading range for the last five years, though it is still well below the range operating during the sixties and early seventies. The progress in the current wage round is likely to be a significant factor determining whether the favourable longer term considerations referred to above will continue to support both this market and the gilt edged market. Assuming reasonable success in this respect, steadily falling short interest rates over the next twelve months, although already widely expected, may well enable both markets to maintain a rising albeit erratic trend. Any prolonged disruption in oil supplies however as a result of the Iraq-Iran conflict could of course radically alter the situation.

Overseas

Currency movements have played a smaller part in returns from foreign investment during the last quarter and any significant further negative impact from this source seems to be less likely.

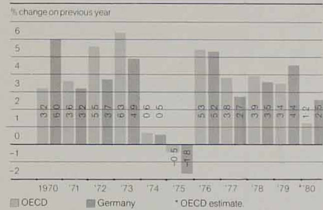
The relatively early recovery from recession that appears to be taking place in the US may be interpreted favourably provided it takes place slowly; while in Japan significant profit increases, particularly from exporting companies, are bringing earnings multiples down to attractive levels. We propose to continue our recent policy of building up investment in both these areas.

German Current Account

DM billion	1973	'74	'75	'76	'77	'78	'79	*'80
Visibles	40·6	57·4	43·3	42·0	46·0	51·2	31·9	15·0
Invisibles	−28·3	−30·8	−33·4	−32·3	−36·2	−33·7	−42·3	−40·0
Current Account	12·3	26·6	9·9	9·7	9·8	17·5	−10·4	−25·0

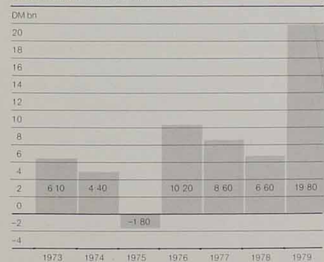
*JHSW estimate.

Real GNP growth: OECD and Germany



1979 was the first year since 1970 in which German GNP growth exceeded that of the OECD as a whole.

Stockbuilding in constant 1970 prices



The changing rate of stockbuilding has had an important impact on the German current account.

Germany: prospects for the current account

The first oil crisis did not precipitate a German current account deficit; on the contrary a record surplus was achieved. This remarkable out-turn was due to Germany's ability to more than offset the increase in the cost of its oil imports through a massive increase in the value of its exports. Particular advantage was taken of OPEC's instantaneously raised import propensity: German exports to OPEC rose 70% by value.

The initial effects of the recent oil price shock for Germany have been very different. Germany's 1980 current account deficit represents more than 30% of the total external deficit of the major industrial countries.

The deficit has made inevitable a modest degree of exchange rate weakness. This has led to upward pressure on domestic interest rates and greater concern about the possibility of importing inflation. However, a sharp improvement in the current account is in prospect for next year. This should have the dual effect of allowing some relaxation of fiscal and monetary policy and a strengthening of the Deutschmark.

Why the current account is in deficit

There are two main reasons for the different out-turn this time. First, the response of other major industrial countries to the second oil price hike has been similar to Germany's rather than very different as in 1973/74. This time a general consensus has emerged that the appropriate response to an increase in energy prices is to restrict domestic demand through tight fiscal and monetary policies thereby keeping inflation under control. The consequence has been that Germany has been unable to repeat its export boom manoeuvre; this problem has been accentuated by OPEC's relative reluctance to spend its surplus.

Second, the importance of speculative and precautionary stockbuilding cannot be over-emphasised. Last year the government initiated a programme to enlarge the national stockpile of a dozen scarce metals from 90 to 365 days' supply. At the same time German oil reserves have risen from an estimated 90 days of supply last year to over 190 days currently. The policy of stockbuilding may have been provoked by the Iranian crisis; the present Iraq-Iran conflict only serves to underline its basic good sense.

Much of the additional oil required to build up stock levels was purchased on the spot market at very high prices. The effect of the oil stock adjustment alone has been to raise imports by more than DM10 bn. which is close to 40% of the deterioration in the current account between 1979 and 1980.

Immediate prospects

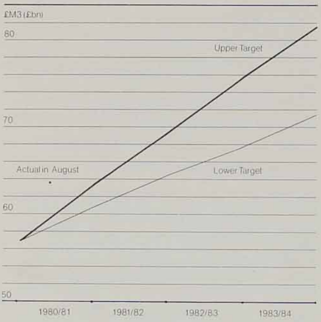
There is now clear evidence that the economy is slowing down sharply. The high cost of credit combined with a further rise in the savings ratio has weakened consumption demand and the government is likely to try more vigorously to curb public expenditure. As a result German demand will cease to grow relative to that of its competitors. The effect of this, in concert with improving German export price competitiveness and its position of strength in OPEC markets, should be a fairly rapid improvement in the current account.

These underlying trends will be reinforced by the stock cycle provided, as is likely, stockbuilding does not continue at the rate experienced in the recent past. The consequence of all this is that the German current account deficit should decline from an estimated DM25 bn. this year to DM10-15 bn. in 1981. A surplus may reappear in 1982.

An upward realignment of the DM is thus in prospect. There are, however, two caveats which limit the amount of the likely appreciation. First, German policy makers will feel bound to support the EMS and will thus avoid putting too much pressure on other member currencies. Second, any movement of the DM will depend on how tight and effective US monetary policy is during the US recovery from recession.

Medium-Term Financial Strategy

Financial Year	1980/81	1981/82	1982/83	1983/84
£M3 Growth	7–11%	6–10%	5–9%	4–8%



The chart illustrates the monetary control problems already encountered. By mid-August the £M3 stock had reached the upper limit targeted for April 1981. In order to meet the objectives of the Medium-Term Financial Strategy in full no more than 20% growth of £M3 should be allowed over the next 3½ years. However a strong argument for rebasing exists. This is because a large, but as yet uncertain, proportion of the £M3 increase in July and August actually reflected unrecorded liquidity growth prior to April 1980.

Government Economic Policy

The Medium-Term Financial Strategy, published in the March 1980 Budget Report, leaves no doubt that the achievement of a progressive reduction in the rate of growth of the broad money supply (£M3) to around 6% in 1983/84 is the central goal of economic policy. Taxes, public expenditure and interest rates are less important and will be adjusted as necessary to meet the monetary targets.

The ultimate aim of the strategy is of course to bring down the rate of inflation to 5% p.a. or less. It is hoped that such a reduction in inflation would be sustainable since it would occur without resort to direct controls on wages and prices. The Government also believes that in the medium term the only way to stimulate growth of real GNP is through measures – some already enacted – to restore incentives and unclog market mechanisms.

It is explicitly recognised in the Budget Report that several factors beyond the direct control of the authorities could temporarily blow the target variables, and hence the economy, off course. Unfortunately exactly such a turn of events has already occurred – with the strategy only six months old. Between April and September £M3 will have grown by 12-13% which is clearly at variance with the 7-11% target for the whole financial year. At the same time the PSBR has been higher than intended even after allowance for the timing of receipts such as PRT payments.

In spite of the rapid monetary growth and higher than planned public borrowing the Government's squeeze has been as fierce as intended. However the mechanism for putting pressure on companies and bringing down the underlying rate of inflation has not been the one originally envisaged. It has been primarily sterling's unanticipated strength and not tight money or public spending cuts which has brought low wage settlements and the prospect of single figure inflation in 1981.

The weakness of the real economy, the strength of sterling and the embarrassingly large recent surge in the money supply together present a difficult policy dilemma – especially with respect to interest rates.

The credibility of the Medium-Term Financial Strategy will be diminished unless very low growth of £M3 is ensured from now on.

At the same time the Government is beholden to the strength of sterling for its current relative success in reducing inflation. A substantial depreciation would shatter hopes of single figure inflation next year and might well have an adverse effect on pay settlements currently being struck.

However the high interest rate/strong sterling policy requires a very accurate assessment of the resilience of the real economy. There are at present alarming signs of weakness: manufacturing output has declined much faster than officials expected while unemployment has risen very sharply. Too much financial stringency could lead to the worst of all worlds. Sufficient damage to the real economy in the form of lost export markets and reduced capacity due to plant closures would necessitate an eventual substantial depreciation of sterling. That would compromise the inflation goal and the retrospective cost of the policy would appear very heavy indeed.

The Government may find it necessary to display some of the flexibility suggested in the text of the Budget Report. An increase in personal taxation combined with relief for companies is not incompatible with the spirit of the strategy: it may be essential to preserve some chance of eventual success.

As successive quarterly 'Perspectives' cover different topics, clients might wish to retain past issues

6th October, 1980

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10 DOWNING STREET

From the Private Secretary

MR. WRIGHT
CABINET OFFICE

Ministerial Committee on Economic Strategy: 2 October

I have consulted the Prime Minister on the question of whether Mr. Prior's employment proposals should be considered on 2 October with a view to announcing decisions at the Party Conference, or later in the month alongside the proposals on public expenditure.

The Prime Minister takes the view that Mr. Prior's proposals must be considered alongside the other proposals on industrial support. And in any event, she thinks it would be better to make any announcement in the Debate on the Address, rather than at the Party Conference.

TPL

22 September 1980

TGR

1

I don't see how we can decide on Oct 2nd with the Chancellor away until that day. The measures must be considered alongside other industrial proposals. In any event - would it not be better for any announcements of this kind to be made in the debate on the Address?

Prime Minister

Mr Prior wants a firm decision on new employment measures in time for the Party Conference. The Chancellor is strongly opposed because he wants them discussed along with other public expenditure proposals later in the month. Will you back the Chancellor?

TL 19/9

Ref: A03037

CONFIDENTIAL

MR. LANKESTER

Ministerial Committee on Economic Strategy: 2nd October

I understand that the Secretary of State for Employment wants his proposals on employment measures to be discussed at the meeting of E planned for 9.30 am on Thursday, 2nd October with a view to announcing decisions at the Party Conference. He is expected to propose doing more under the Youth Opportunities Programme to help unemployed 16-17 year olds, and also to propose measures enabling long term unemployed adults to do work of value to the community which might not otherwise be carried out. The costs of these schemes have not yet been cleared with the Treasury, but they are provisionally expected to involve an additional £350 million gross in 1981-82 or about half that if allowance were made for the consequential savings of employment benefit and also for receipts from the European Social Fund. There are no proposals at this stage for continuing these measures into later years.

2. The Chancellor of the Exchequer is however against taking final decisions on these proposals in advance of the decisions on public expenditure which will first be discussed by Cabinet on 30th October. If the Chancellor's view prevails it is doubtful whether it would be worth having a preliminary discussion of the proposals at the meeting of E on 2nd October, particularly since the Chancellor himself will not arrive back in London from the IMF Conference until early that morning and therefore may not be able to take part in discussions in E.

3. If it were agreed that it would be preferable to defer discussion of employment measures until after the Party Conference, they could be taken in E at the same time as the paper which the Chancellor is to circulate on Industrial Support Measures and also possibly a paper from the Secretary of State for Employment on Training. This would also mean that the meeting of E on 2nd October would take business for which the Chancellor's presence would not be essential.

CONFIDENTIAL

4. You will no doubt wish to discuss this point with the Chancellor's Private Office and also consult the Prime Minister. I should be grateful if in due course you could let me know your views so that we can formulate an agenda for the 2nd October meeting.

DJ Wright

(D. J. Wright)

19th September 1980

w hankester

19 September 1980

Policy Unit

Econ Pol

PRIME MINISTER

ECONOMIC STRATEGY

I mentioned that we are preparing a paper doing a reappraisal of strategy, primarily economic but also touching other things. I thought you might like to see a note from Douglas summarising our discussions over recent months. You may also like to have another look at a minute we did for you before the last Budget which foreshadows some of the things we are now thinking about again. I have marked the relevant parts in red.

JOHN HOSKYNS

11 September 1980

WHERE WE ARE NOW

1. Since June 1979 the balance of macro-economic policy has been wrong. We cut taxation before we were certain that we could restrain public spending.

2. This led to a high PSBR at a time when inflation/recession were keeping private sector borrowing high. Gilt sales were not large enough to prevent the combined (public plus private) demand for money from raising £M_3 in 1980 at an annual rate of over 15%. This rise was masked by the "corset" so that remedial action was delayed.

3. Market prices led to high interest rates. They would have been even higher but for intervention by the Bank of England.

4. Macro-economic policy has been lopsided, with too much emphasis on monetary policy and too little on fiscal. Monetary policy itself has been lopsided, with inadequate control of the quantity of money leading to excessive interest rates. Pressure on the economy has been lopsided, with too little on public spending and too much on private; too little on wages and salaries and too much on profits; too little on the employed and too much on the unemployed; too little on public current spending and too much on public capital.

5. Despite our failures, inflation has come down. This is partly because of world recession and high interest rates, but mainly because of the high exchange rate.

6. No-one knows how far the high exchange rate results from high interest rates, how far from North Sea Oil and how far from the recession.

7. Most commentators underestimate the importance of structural changes in the UK. North Sea Oil represents a major new export. Because total export volume is not increasing, it follows as a matter of arithmetic that other net exports must be falling. This is hitting the net exports of, eg, textiles and simple metal/engineering products.

8. The development of manufacturing capacity in LDCs is mainly hitting companies producing these same products.

9. It is difficult for us to separate the effects of faulty macro-economic policy from those of the structural changes. It is therefore preferable to allow market prices to reshape the economy. They may be impersonal, but we are ignorant. Moreover, 'solutions' often seem to require reductions in real income. The TRG wants to deal with North Sea Oil revenues by the Government investing much of them overseas. But this would raise the PSBR or require a similar amount of revenue to be raised from other taxes. And most of those who want a lower exchange rate forget that this will raise prices and so reduce real incomes.

10. I therefore strongly argue that we should not do <u>anything</u> to interfere with North Sea Oil or the exchange rate, certainly until we have removed the distortions we have ourselves introduced.

11. The first priority, as I have argued since June 1979, is to restore the fiscal balance and so reduce interest rates. This will presumably reduce the exchange rate too. When Government-induced distortions are out of the way, that will be the time to get a better sense of what the effects of the structural changes are, and whether we should try to soften them. As Sam Brittan says, we must see that we <u>under-shoot</u> the monetary targets from now on - by 1-2% pa.

12. There is a caveat. We must restore the fiscal balance mainly by cuts in public spending. We may need to raise some taxes, but we must avoid asset sales and pressure to increase nationalised industry prices above commercial levels. That would only put even more pressure on the private corporate sector.

DOUGLAS HAGUE

Spare

12 March 1980

PRIME MINISTER

Here are some comments on the points raised in your discussion with the Chancellor last Friday. I would like to have got it to you in time for your meeting with him this evening, but the PPB and Bournemouth preparations have put us rather behind.

1. WHAT ARE THE BUDGET'S OBJECTIVES?

1.1 The Budget must convey a clear message and sense of purpose. It must not appear to be a return to Healey-style ~~bickering~~. tinkering.

1.2 The main message must be the commitment, over time, to ending inflation. Our scope here is limited by our failure to de-index on an adequate scale in public expenditure.

1.3 The Budget must be seen as fair as well as firm. Its measures, its objectives, and measures we have already taken in the past, must all hang together coherently.

2. COMMENTS ON CHANCELLOR'S PROPOSALS TO DATE

2.1 For the above objectives, the most important of Geoffrey's proposals must be the proposal to set out a medium-term financial plan related to the PSBR and the growth of the money supply. It both demonstrate our commitment and also reminds people that the cure takes time. The Governor's objections last Friday don't add up to much. It's th old chicken-and-egg argument. The Government does not "take responsibility for continued slow growth", simply because it publishes its best forecasts on what will happen. When the Governor says that "wages might not accommodate to the declining monetary pat is he saying that it is better that we should not tell the operators in the economy too much about the path to which those wages have to accommodate? Is he forecasting the necessity for a freeze? Isn't a freeze more likely to be avoidable if the maximum information is given to ensure that behaviour within the economy is compatible with the monetary path? It's certainly true that we're finding it hard to stay within the existing one-year target - but is that surprising with £18bn a year of auto-indexed public expenditure? This whole

In the event it wasn't.

exercise is presumably part of a bigger and properly worked out programme to get all that under control. Other colleagues may raise similar time-honoured objections, but they all amount to a sub-conscious desire to avoid announcing that you're going to try and do something difficult, in case you fail. And they completely overlook the effect of that announcement on, first steeling the Government's own resolve and, second, altering expectations in the economy.

2.2 You raised a number of points on Geoffrey's proposals. Here are some comments:

(a) Abolition of the reduced rate band may have undesirable distributional and incentive effects - though the latter are unavoidable if income tax is to be raised in real terms. Abolition would look divisive, especially since - I believe - the introduction of the reduced rate band followed a sustained campaign by the TUC.

(b) We believe there are compelling reasons of fairness, longer-term coherence and avoidance of anomalies in favour of some moves on fringe benefits. Any real increase in their taxation could be quite modest and therefore symbolic. (To abolish the reduced rate band of income tax <u>and</u> leave fringe benefits untouched would look very unfair when we are telling the country that we are going into some very rough weather.)

(c) Corporate liquidity indications look increasingly grim. I am sure Keith is right to press for reductions in NIS rather than the much slower and more indirect (and widely spread) benefits of a lower PSBR. Of course, pressure on the corporate sector to adjust to the harsh realities must be maintained, but there is a limit to how fast the adjustment can happen.

(d) We still feel that there is scope for extending the principle of partial de-indexation, though I realise that this would need fresh Cabinet consideration on public expenditure. There are two quite distinct purposes here. First, there is the need to reduce public expenditure in the short term. Second, but quite different, is the need to start the process of matching the deceleration of money incomes to the deceleration of our monetary growth. To date, our thinking has been quite misconceived. We have assumed that the monetary deceleration would start in the private sector, under pressure of unemployment and bankruptcies (despite the tenuous connection between the actions taken by fiercely-competing unions, and the results of those actions). Meanwhile, the rest of the system (public sector pay under Government influence, and social security payments under Government's complete control) have remained fully indexed! We have tackled it completely the wrong way round. Everything that Government pays out should have been immediately partially-indexed (we can't now undo the commitment on pensions, though even those could have been de-indexed rather less, for symbolic purposes, than other social security payments, as part of a really purposeful package to cut inflation). After that comes heavy pressure on the public sector and then finally the private sector or what's left of it. I found Ken Berrill's minute of 27 February very disappointing. It presumably reflects Gordon Downey's view, who was on the Wass group. The penny never really dropped with that group; the need for the "change of gear" didn't seem to be grasped; confusion between cutting public expenditure on one side, the monetary deceleration on the other, was total; and there was vigorous ~~defence of~~ resistance to anything less than full comparability in public sector pay! Another boat missed.

Downey is normally good
And the penny is now starting to drop.

(e) If it's too late to do any more de-indexing, it might be possible to squeeze a little more tax out of the oil companies so that the de-indexation of Rooker-Wise could be brought into line with the de-indexation on unemployment benefits. It seems sensible that they should both be at 5% so as to establish the pattern of equal treatment for extending de-indexation, as I am sure we will have to do as we find inflation coming down too slowly.

3. WILL WE NEED SOMETHING MORE?

3.1 I made the points in 2.2 (d) to Geoffrey on 20 February but it was probably already too late for any new insights to be useful. The problem was that the indexation study took place so late that its results could not be properly digested and it is probably now being put away in the files as an academic exercise. The result is that the public expenditure cuts have not created enough manoeuvring space for anything but a tinkering Budget - redeemed, I hope, by a medium-term forecast. There must be a strong possibility that we will have to do something else on more Hayekian lines some time in the next year (ie along the lines of the "shock package" I suggested in January).

JH

JOHN HOSKYNS

PART 6 ends:-

Terry Burns to Ch Ex 3.9.80

PART 7 begins:-

Hoskyns to PM 19.9.80