PREM 19/709

Economic Strategy

Pay and Prices Monthly Economic Report

The Economic Project

PART 13.

ECONOMIC POLICY

Part 1: May 1979

Part 13: Jan 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~13.1.82~~							
1~~9.1.82~~							
~~25.1.82~~							
~~1.2.82~~							
10.2.82							
~~17.2.82~~							
19.2.82							
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PART 13 ends:-

8/5 Emp to PM + att

PART 14 begins:-

26/2/82

~~D. Wright to MCS 22/2/82 A07578~~

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC (82) 2nd Conclusions, Minute 2	21.1.82
E(82) 6	1.2.82

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 AWayland   Date 16 August 2012

PREM Records Team

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Prime Minister

MLS 19/2

PRIME MINISTER

PAY BRIEF

I attach my Department's pay brief for February. I am sending copies to members of E, E(PSP), and E(EA) Committees, and to Sir Robert Armstrong.

N T

19 February 1982

PAY BRIEF: POSITION AT MID-FEBRUARY

SETTLEMENTS

1. Since the January pay brief 92 settlements covering 1,493,000 employees have been recorded. In the private sector (86 settlements covering 193,000 employees) the weighted average level of settlements in the last month was just over 7%. The average in the public sector (6 settlements covering 1,300,000 employees) was 7%. The principal settlements were Coalmining (198,000) at 7.44%, Local Authority manuals (1,077,000) at 6.9% and a 2 year staged agreement for Plumbing E&W (30,000) giving increases of 9%-9½% in the first year and about 22% overall.

2. The cumulative average level for the whole economy this pay round - 381 settlements covering 3,220,000 employees - is just over 7%, similar to last month. Just over ¼ of employees about whom the Department expects to receive information have reached settlements.

3. In the private sector the cumulative average remains unchanged at just over 6½% (369 settlements covering 1,701,000) employees). For manufacturing the average level is just over 6% and in non-manufacturing is just over 7%. The bulk of recent settlements are in a 5% to 8% range which covers about ¾ of settlements and employees.

4. In the public sector (12 settlements covering 1,520,000 employees) the settlements for Coalmining and LA manuals have reduced the cumulative average to just over 7½% from about 11½% in January.

NEGOTIATIONS

5. In the PUBLIC SECTOR, unions representing Gas Supply manuals (17 January - 41,300) have been made an offer of 8.5% on basic rates with some improvement in the flexibility allowance, worth 6.8% overall on average earnings, and are to consult their members on the offer. The claim is for an increase in rates in line with inflation, consolidation of bonus, shorter working week and other benefits. Electricity Supply manuals (17 March - 94,000) have rejected an offer of £5 to £8 on basic rates, improved shift pay and holiday entitlement - estimated at about 5% to 7% on average earnings. The claim is for a substantial increase in pay, shorter working week, longer holidays and other benefits. Meeting arranged for 4 March. The unions representing UKAEA manuals (1 October - 4,750) are consulting members on an offer of 5% on rates and 1 hour reduction in the working week - worth 5.5% on the paybill.

Four of the 5 sites have accepted. The Non-Industrial Civil Service unions (1 April - 520,000) have submitted a joint claim estimated to add about 14% on average to basic pay rates plus 1% for leave improvements. The Government's offer reflecting market forces (including recruitment and retention) and management needs was put to the unions on 16 February- it would provide for no increase in pay for some staff and increases ranging from 1% to 5½% for others, together with improvements in skill and responsibility allowances and the introduction of certain other benefits including season ticket loans. The cost is estimated at £170m or about 4% on the paybill. The unions' response was that the offer provided no basis for further negotiation and they would be seeking an early reference to arbitration. Further exchanges on this are expected shortly. Primary and Secondary Teachers E&W (1 April - 460,000) have submitted a claim for increases in line with inflation. An offer worth 3.4% on the paybill was rejected without detailed discussion. A further meeting has been arranged for 3 March. Local Authority building trade operatives (6 November - 76,000) have rejected a cash offer of £4.60 (5.5%) on basic rates - estimated at about 4% on earnings - and are seeking increases of up to 7.8%, the same as the LA manuals. Negotiations are continuing. A claim by NHS Ancillaries (1 April - 210,000) for a substantial increase, reduction in the working week and improved holidays is being considered. Meeting arranged for 26 February. NHS Nurses and Midwives (1 April - 492,000) have submitted a similar claim and will expect an offer to be made at a meeting on 23 February. The Review Body for NHS Doctors and Dentists (1 April - 85,000) is expected to report in April. The doctors and dentists are claiming 12½% and 13%, respectively, which includes 3% due from the previous award. British Airways employees (1 January - 50,000) have generally accepted the management proposal for a pay freeze until September 82 when the situation will be reviewed. All the unions representing British Steel Corporation employees (1 January - 108,000) have now accepted the proposal that any pay increases in 1981/82 must be linked to productivity deals negotiated at local level. In return BSC has agreed to consolidate some productivity payments, improve certain pension conditions and introduce a 39 hour week from 1 January 1983.

6. In the PRIVATE SECTOR, offers in the range of 5.0% to 8.6% on basic rates, have been made in all 21 areas of the Road Haulage Industry (Nov/March - 97,000). Twelve areas have accepted offers of 5.6% to 8.6%. Talks are continuing in other areas. Unions on behalf of Newspaper Publishers Association production workers (1 January - 33,000) have balloted on a 5% 'final' offer. Members of NATSOPA and SLADE have accepted, but SOGAT has rejected. The result of the NGA ballot is expected soon. The claim is worth about 15%. The two unions representing London Clearing Banks clericals (1 April - 146,000) have presented claims for 15% and 23% increases.

An offer of 7.5% has been rejected. Next meeting is on 23 February. A revised offer of 7% plus 2½% cash bonus for Guardian Royal Exchange staff (1 January - 8,700) is being recommended by the union for acceptance. A revised offer for Multiple Baking production workers (30 November - 20,000) worth 8½% is to be put to a ballot of union members. Talks have resumed in Furniture Manufacture (1 January - 70,000) following a breakdown in negotiations after rejection of a 5.3% offer. The claim is for substantial increases in line with the cost of living. Biscuit Manufacture workers (1 January - 39,000) have rejected a 6.5% offer. The claim is for 11.5%. Next meeting arranged for 19 February.

PRICES AND EARNINGS INDICES

PRICES

7. In January the year on year increase in retail prices was 12.0%, the same as in the two previous months.

EARNINGS

8. In December the year on year increase in average earnings for the whole economy was 9.9% compared with 11.3% in November. However, back-pay to Local Authority manuals in December 80 substantially depressed the 12 month change; the underlying increase was about 11%, broadly the same as in the previous four months.

REAL DISPOSABLE INCOME

9. The real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 3% in the year to November.

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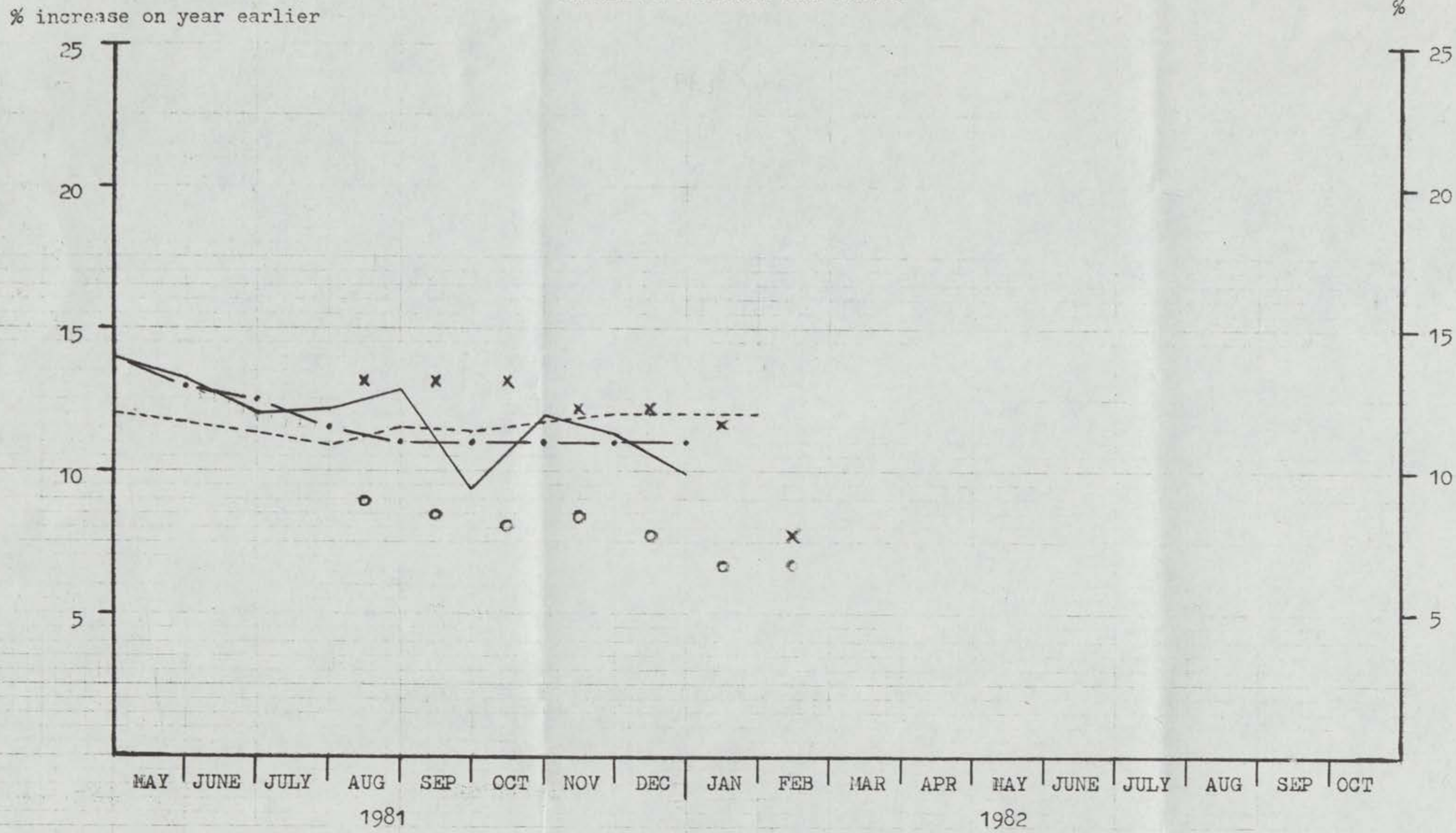
APPENDIX I

TRENDS IN EARNINGS AND PRICES



- - - - Retail Price Index

——— Average Earnings Index (whole economy)

· —— · Underlying rate of increase in earnings

× Public Sector Settlements)
○ Private Sector Settlements) Cumulative Average Increase in Earnings

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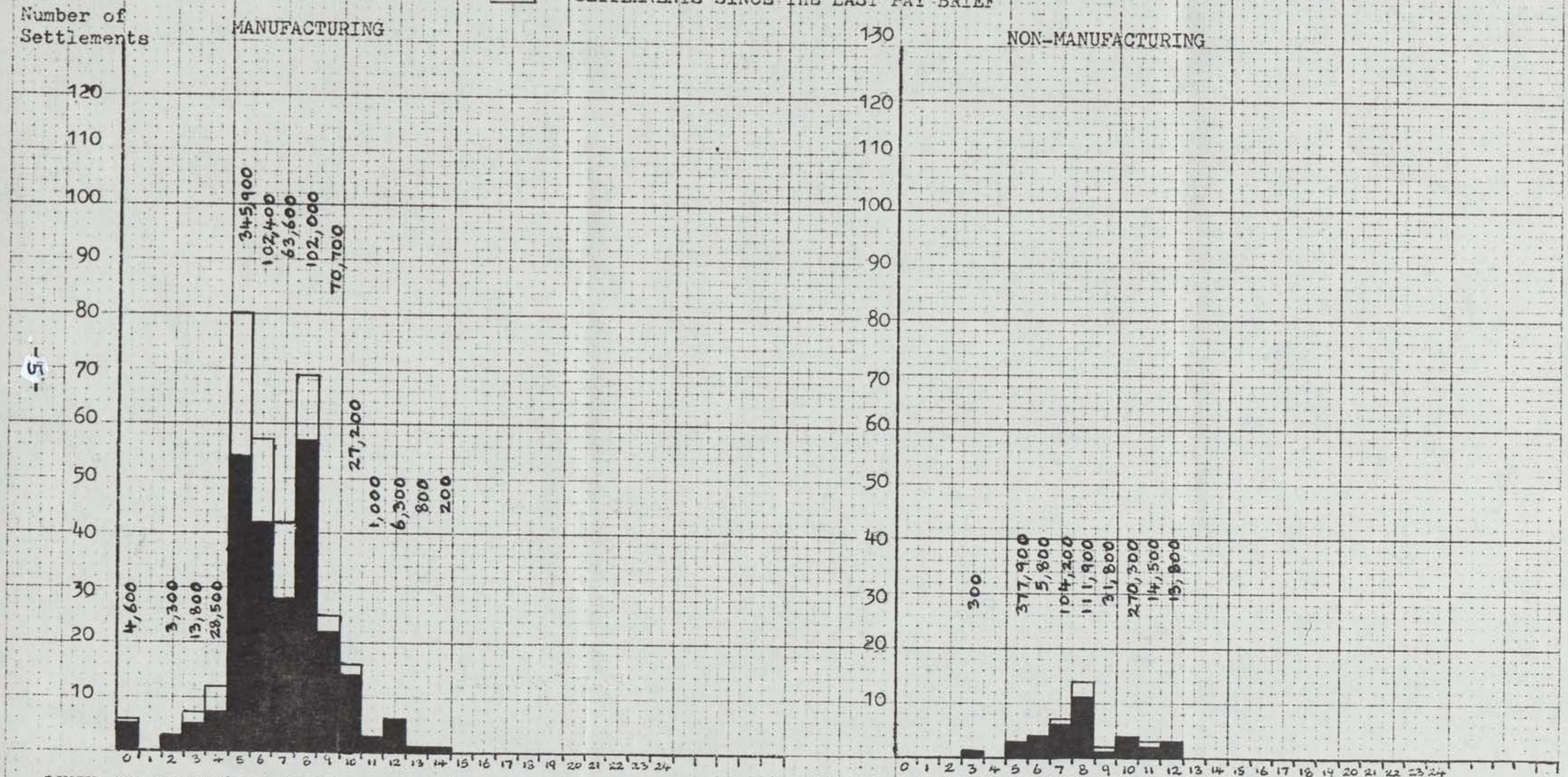
APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981

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

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Mr Scholar

Your Ref

with compliments

R G LAVELLE

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GR 35Ø CONFIDENTIAL

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FM UKDEL IMF/IBRD WASHINGTON 20015ØZ FEB 82

TO PRIORITY F C O

TELEGRAM NO 36 OF 19 FEBRUARY

IMF discussion of UK economy.

IMF: UK CONSULTATIONS

1. THERE WAS A FULL DISCUSSION, IN WHICH MOST DIRECTORS SPOKE. MANAGING DIRECTOR'S SUMMING UP FOLLOWS BY BAG. MAIN POINTS MADE WERE AS FOLLOWS.

2. BROAD SUPPORT WAS EXPRESSED FOR THE OBJECTIVES AND APPROACH OF THE ECONOMIC STRATEGY, AND FOR THE VIEW THAT SUSTAINABLE GROWTH REQUIRED LOWER INFLATION AND BETTER PRODUCTIVITY. CONCERN WAS HOWEVER EXPRESSED ABOUT THE HEAVY COST IN TERMS OF THE REDUCED OUTPUT AND EMPLOYMENT, AND ABOUT THE UNCERTAINTY WHEN THE LONGER-TERM OBJECTIVES WOULD BE ACHIEVED.

3. MOST DIRECTORS ACCEPTED THAT IN SPITE OF THE OVERSHOOT OF THE STERLING M3 TARGET RANGES, THE DEGREE OF FINANCIAL STRINGENCY HAD INDUCED A SIZABLE REDUCTION IN INFLATION. THEY NOTED THAT NO SINGLE MONETARY AGGREGATE WAS LIKELY TO BE A WHOLLY RELIABLE TARGET VARIABLE, BUT AGREED THAT TARGETS SHOULD BE SET AS A BROAD GUIDE TO POLICY.

4. THE IMPROVED PRICE AND WAGE PERFORMANCE IN 1981 WAS RECOGNISED, AND CONTINUED MODERATION WAS SEEN AS ESSENTIAL. QUITE A NUMBER OF DIRECTORS FELT, HOWEVER, THAT IN SPITE OF THE DEPRECIATION OF STERLING DURING 1981, THE PRESENT LEVEL OF THE EXCHANGE RATE WAS AN OBSTACLE TO A SUSTAINED RESUMPTION OF GROWTH, AND SUGGESTED THAT SOME FURTHER DEPRECIATION WAS WARRANTED PROVIDED THAT THE INFLATIONARY EFFECTS COULD BE CONTAINED, WITH SOME DIRECTORS BELIEVING THAT SOME FORM OF INCOMES POLICY OR CONSENSUS MIGHT PLAY A PART IN THIS PROCESS. STRONG SUPPORT WAS EXPRESSED FOR THE EFFORTS TO CONTAIN PUBLIC SECTOR PAY.

5. DIRECTORS COMMENTED THAT THE BUDGET NOW APPEARED TO BE IN BETTER CONTROL, BUT THAT FISCAL RESTRAINT HAD BEEN ACHIEVED BY RAISING TAXATION AND CUTTING PUBLIC INVESTMENT. DIRECTORS ENDORSED THE STAFF VIEW THAT IF THERE WAS ANY ROOM FOR TAX CONCESSIONS THIS SHOULD BE USED TO REDUCE THE BURDEN ON THE COMPANY SECTOR, BUT THAT IT SHOULD BE LIMITED BY THE NEED TO REDUCE PUBLIC SECTOR BORROWING RELATIVE TO GDP.

6. DIRECTORS WELCOMED THE CONTINUED OPENNESS OF THE ECONOMY TO INTERNATIONAL TRADE AND FINANCE, BUT REGRETTED THE REDUCTION IN OVERSEAS AID AND HOPED THAT THIS WOULD BE REVERSED.

7. FULL REPORT OF DISCUSSION FOLLOWS BY SAVINGRAM.

8. PLEASE ADVANCE TO LAVALLE (TREASURY) AND GILCHRIST (BANK OF ENGLAND).

ANSON [ADVANCED AS REQUESTED]

FINANCIAL

ERD

CONFIDENTIAL

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17.2.82

→ Professor Alan Walters.

With the Compliments of
Edmund Goldberger

and kind regards

MS

Prime Minister

I would far rather rely on Edmund Goldberger than Melvyn Westlake who wrote the article in the Times.

AW 18/2

01-723 5432

20 Albion Gate
London, W2 1AA

PERSONAL.

20, ALBION GATE,
LONDON, W2 1AA.
(01) 723 5432.

17 February 1982.

Dear Mr. Long,

Having seen yesterday's Kershaw interview with Professor Milton Friedman on BBCTV I could not believe, when reading The Times to-day, that the author of your description of it had watched the same programme.

Your heading on p.1. "Friedman turns on Thatcher" is a distortion of facts. Friedman went out of his way to support Mrs. Thatcher, stressing that he would not criticise her personally. Specifically he thought that her efforts and policies had been frustrated by the bureaucracy and insufficient support within the Conservative Party, citing the difference between Mrs. Thatcher and President Reagan's more favourable position.

On p.13 your heading reads "Friedman attacks Thatcher policies". Quite misleading. At no point did he "attack", nor did he criticise "<u>policies</u>". He criticised their execution and deplored this failure.

The conclusion by those who watched this programme is bound to be that false attributions and distortions are now allowed in a Paper which traditionally expressed pride in the accuracy and objectivity of its reporting--as distinct from expressing one's own opinions.

Those who use foul means to attack Mrs.Thatcher such as misrepresenting other people's views and whose motivation led to deliberate distortion,committed an offence against the reputation of The Times.I said deliberate,because presumably you would not employ people who are not intelligent enough to understand what was clearly stated.

The mere fact that I am addressing this letter to you personally is already an indication of concern that this protest should not end up in hands committed to bias.and not be noticed.

Yours sincerely,

Edmund Goldberger.

Edmund Goldberger.

Mr.Gerald Long
Managing Director
The Times
Grays Inn Road
London WC1

BBC Press Release BBC Press Release BBC

PROFESSOR MILTON FRIEDMAN ON AMERICAN ATTITUDES

The guest in 'American Attitudes' on Tuesday, February 16 at 11.40pm on BBC-1 is Professor Milton Friedman, who was interviewed at Stanford University, California, by Richard Kershaw.

"I am a short-period pessimist, but a long-period optimist," says Professor Friedman. "America is fundamentally a very healthy and a very strong economy."

"Within less than a year....the United States could be on the path to a very healthy, long sustained, non-inflationary expansion."

Professor Friedman takes a gloomier view of Britain's economy. "You are desperately sick", he says. "What you have, that you did not have five years ago, is at least one coherent group, that has a well-designed, well-articulated programme for getting you out of the mess. But so far you haven't been able to carry that out."

However, Professor Friedman argues that the situation is "very far from bleak in the United Kingdom".

"The sort of process through which your private sector has gone has been healthy, though much too costly, much more costly than it need have been. As a result I would not be surprised if, in the next two or three years, Britain experienced a rather significant economic revival. However, I don't believe you'll have any long-run success until you cut your Government down to size."

Any part of the above, or the attached transcript may be reproduced providing BBC-1 and the 'American Attitudes' programme is acknowledged as the source.

For further information: Press Office,
BBC-tv Centre, London, W12.
Tel. 01-743.8000 Ext. 2865/9

16.2.82

AMERICAN ATTITUDES

PROGRAMME THREE

TRANSMISSION: BBC1 Tuesday 16th February 1982

11.40 p.m.

RICHARD KERSHAW

talking to

PROFESSOR MILTON FRIEDMAN

Kershaw For the third in this series of interviews with prominent Americans, I've come to California, to the campus of the University of Stanford. Here resides Professor Milton Friedman, the Nobel prizewinner and the father of monetarism, the economic theory which dominates Government policy in both Britain and America. President Reagan and Mrs. Thatcher came to office committed to the principles of monetarism, but now the American economy, like ours, is beset by recession, inflation, high unemployment and soaring interest rates.

Kershaw Professor Friedman, how bad, in simple terms, is the current economic state of America, which affects us so deeply?

Friedman It's not very bad, we are not at the height of prosperity, we are not at the depths of depression, we are not in a long rate - range decline, I am a short period pessimist, but a long period optimist, America is fundamentally a very healthy and very strong economy.

Kershaw But we have inflation, we have recession, we have huge deficits, high interest rates, all at the same time. Again, in simple terms, what has been going wrong?

Friedman Well first of all what's been going wrong is a misuse of adjectives. We do have inflation, but inflation has been coming down for 2 years, it is lower now than it has been for 3 or 4 years, it will continue to come down next year. The inflation front is the one front on which you can be optimistic. We do have a recession, but the recession is so far not very different from earlier recessions, we have had such recessions for well over a hundred years, this one isn't going to last for ever. While unemployment is up, you must remember that unemployment under today's circumstances, with very generous unemployment benefits and other perquisites, is not - does not cause the kind of hardship which unemployment used to cause, moreover, I don't know that your citizens would know that of all unemployed people who are unemployed today, something like over a half of them will have jobs in 4 or 5 weeks. The people who are unemployed are not a steady lump of people, they're a constantly shifting people, and most people are on lay-offs, they're laid off by a company, and they'll be brought back. So while unemployment is undesirable, it is not a tragedy at the moment.

Kershaw Well that's a very confident picture. Now let me ask you one thing - in Britain President Reagan is seen as an ardent monetarist, but is he? Are Reaganomics monetarist? In other words do they have the Friedman seal of approval?

Friedman Monetarism is a term that has been much misused to cover more than it does. Monetarism has to do with controlling the quantity of money. Both Mrs. Thatcher's programme and President Reagan's programme is one part monetarism and three parts something else. The one part monetarism is to maintain control over the quantity of money. The other three parts are to cut taxes, to cut spending and to get the Government out of the business world. Those three parts have nothing to do with monetarism. In my opinion President Reagan has over and over again stated and believes strongly that control of the money supply, and a steady reduction in the rate of growth of the money supply is absolutely essential to bring down inflation. In that sense he is a monetarist. But let me emphasise, that unlike the situation in Great Britain, President Reagan does not control the monetary authority, the Federal Reserve System is independent.

Kershaw Is independent, yes.

Friedman Whereas the Bank of England is essentially under the control of the Chancellor of the Exchequer.

Kershaw Now I know all the different parts of the economy are inter-related, but can I take broad areas separately for convenience. First, Mr. Reagan's assault on inflation, which like Mrs. Thatcher he has made the public enemy Number One. How firmly is inflation coming down, is it on a definite trend or is it only short-term?

Friedman Oh inflation is on a definite down trend, but for how long depends not on Mr. Reagan, but depends fundamentally on the Federal Reserve Board. If the Federal Reserve Board continues following the average policy, I'll come back to the deviations from the average, but if it continues following the average policy of the last 3 years, inflation will keep on coming down. By the end of this coming year of 1982, I will be surprised to see inflation for consumer prices much above 5 or 6 percent.

Kershaw Which is getting very low ... (together) ....

Friedman Oh yeah, well a year ago it was 12 percent.

Kershaw How strong are the pressures on Mr. Reagan, or should I say on the Federal Reserve, to loosen up on the supply of money? How strong are the political pressures on him?

Friedman They are very strong indeed. Every time you get a recession, this has been the history of the last 30 years, and if we go back to the same behaviour as we've behaved on - behaved for the past 30 years, you'll have the same result. But every time there's been a recession there's a great cry goes up, it becomes politically profitable to press for more money being produced; there is a great deal of pressure on him.

Kershaw Well the second area that I want to ....

Friedman However, I want to add, that pressure is not what it used to be, because the American people are getting more sophisticated. If 5 years ago you had asked the American people - polls did ask the American people - what causes inflation? You would get answers like - Trade Unions or business people, and so on. Today you will get a large majority saying -it's increasing the quantity of money that causes inflation.

Kershaw So you've been winning your one man campaign.

Friedman No I haven't been winning, the facts have been winning.

Kershaw Come onto another thing. Mr. Reagan has been doing something else, which you raised yourself, cutting taxes, now in a very very large way. We're talking about half to three-quarters of a trillion dollars, or something, coming out of taxes, over a 4 to 5 year period. But can you do that at the same time as reducing the money? Don't you get a vicious circle?

Friedman Not at all, no, no, not at all. First of all the real burden on the American people is not what's called taxes, but what the Government spends. If the Federal Government spends close to 800 billion dollars next year, which is projected, and if it takes in something like 700 billion, who pays the other 100 billion? It comes out of the hide of the American taxpayer one way or another. So that the real thing to keep your eyes on are total Government spending, and from that point of view you have to cut taxes in order to cut spending, because it's the only way you can bring pressure, on Congress, to hold down the Budget.

Kershaw Didn't Mr. Reagan get very strong advice from all his advisers, including the Head of the Federal Reserve Board, to raise taxes -

Friedman No.

Kershaw In order to reduce the deficit in the current -

Friedman No, no.

Kershaw In the current budget.

Friedman No, no, he did not. Mr. Reagan happens to have a very wide range of advisers. He is the first President, in my memory, who has consistently and regularly called on outside advisers as well as those in the Government. And I can tell you, as one of those outside advisers, that I was strongly opposed to his increasing any taxes and I strongly supported the position he took in the State of the Union message. And recall what he said in that State of the Union message. He said - my coming out for increased taxes will not reduce the deficit, it will only increase the amount the Government spends, and I think he's a hundred percent right in that.

Kershaw Hasn't Mr. Reagan changed his economic theory, though, a bit, because he came in vowing to get rid of deficits, to balance the Budget, and here he seems to have bowed to the inevitable, with that great political skill of doing so.

Friedman — Yes, there's no doubt that that's true. During his campaign he overpromised, as politicians are not - that's not exactly unique with President Reagan, and he did promise to do something he should never have promised, he should not have promised to get the Budget balanced by 1984, because that is not a realistic possibility, and was never a realistic possibility. On the other hand, I think he has done the right thing by sticking to the fundamental elements of his programme, and not being forced off track on them, by the public concern about the deficit.

Kershaw — Now there's another side to this policy, which seems to me to be about a huge act of faith, what I think Vice President Bush called voodoo economics, that this is the one that by slashing taxes everybody's going to jump up and down and create new wealth and new businesses, and that all the figures will come out right in the end. Isn't this a huge act of faith?

Friedman — Well overstatement and overpromising is a huge act of faith, but the belief that if you cut tax rates, people are going to use their time more usefully than finding tax shelters, is certainly not an act of faith. Does anybody in Britain regard it as an act of faith, that if you cut the tax rates people pay they'll spend less time rushing around trying to find ways to get around taxes, is that an act of faith? Or is that the most obvious fact that all of us have observed in our life?

Kershaw — No, but that much - that much greater wealth would be created by this act is simple supply side economics ....

Friedman — That is not an act - that is not an act of faith either, it's the record of all of history. Why is it that the countries which have, over the past 100 - 150 years, relied most heavily on free markets, without Governments' involvement, why is it that they are the countries that today are the wealthy countries in the world, and the countries which have not done so, are the poor countries of the world. Do we really need some more Polands, to demonstrate that it is not an act of faith, that allowing people to pursue their own interests in their own way, with a minimum of intervention by the Government, is a way to have a strong, healthy, prosperous economy? Do we need many more Britains to show that? When was Britain strongest? Tell me, was Britain in a better economic state or a worse economic state, relative to the rest of the world, during the latter half of the 19th century, when Government was smaller than it has been during the latter half of the 20th century? Which is the more healthy?

Kershaw — Well a higher number of people now at least eat properly in Britain.

Friedman — Of course, but a high number of - you have to look at progress. We stand on the shoulders of a century ago, and at the end of the 19th century the fraction of British people who were eating better, than they had been a century earlier, was much larger than any comparable change between then and now.

Kershaw Can I take you on to another area, which is interest rates. Now interests rates are historically high in America.

Friedman Absolutely.

Kershaw Aren't they bound to stay high, like that, while these deficits are being run?

Friedman Not at all, not at all. The interest rates embody a number of different components. One of them is the inflation rate, and the inflation rate comes down, interests rates will come down, regardless of the decifit. After all, let me say, in 1976 we had deficits which were larger, as a fraction of income, than they are now going to be, and interest rates then were much lower than they are now.

Kershaw Well they have stayed up, and aren't they deeply damaging in themselves?

Friedman Absolutely, there's no question that they have stayed up, there's no question that they've been unprecedentally high, there's no question that they're as deeply damaging.

Kershaw Are they inflationary, as part of that damage?

Friedman No, they're not inflationary, that's a different question. But the question is why have they stayed so high? And the answer is, in my opinion, fundamentally traceable to our monetary authority. And that is that they have followed - well on the average they've behaved quite well, they have done so by being highly erratic. You know about the 6 foot man, who drowned while he was crossing a river that averaged only 5 feet in depth. Well it's the same thing, the average performance of the Fed has been reasonably good, but the week to week, month to month performance has been absolutely disgraceful.

Kershaw Now can I take you on to the European, and particularly the British view. We feel that those high interest rates are actually damaging us, they're hurting us more than anything.

Friedman Our high interest rates are not hurting you. Your high interest rates are hurting you, and your high interest rates are a product of British policy and not of American policy. That would not be true if we had fixed exchange rates, but we don't, we have floating exchange rates, and in a world of floating exchange rates you can have any interest rates you want, regardless of what interest rate we have.

Kershaw Isn't America, though, being, I think selfish might be a rather silly word to use, but being selfish in crude terms, or isolationist in pursuing this high interest rates, which is -

Friedman We are not pursuing this high interest rate policy, the high interest rate - I mean we are not pursuing a high interest rate policy. The current high interest rates, in my opinion, are a consequence of a failure of policy, they're not a deliberate policy. There is nobody in the White House, in the Congress, or in that Greek temple on Constitution Avenue, which houses the Federal Reserve System, there's nobody there who has a policy of high interest rates.

Kershaw But there are high interest rates.

Friedman Right.

Kershaw And they do have an effect on us.

Friedman Of course, they have a bigger effect on us. If you say selfish, you mean to say that we are masochists, or sadists, or that we're sufficiently sadistic to want to inflict punishment on you at the cost of big punishment on us? That's absurd. Our high and erratic interest rates are a result of bad policy by the Federal Reserve, in my opinion, and do not reflect any deliberate policy.

Kershaw Can I ask you how you think we are doing, in the United Kingdom? We've had Mrs. Thatcher in since 1979, came in on a firm monetarist policy; how do you think the performance of the British economy matches up?

Friedman Terrible, terrible. The British economy, to begin with, was in a much worse state than the American economy is. Mrs. Thatcher's programme, in its basic four elements that we mentioned before, is identical with President Reagan's. The crucial question, however, is not one of promises but of performance, and of Mrs. Thatcher's four elements, she has been able to accomplish only one, and that one, as in the United States, in a very imperfect way. The only one she has accomplished, incidentally, is a monetarist one. The quantity of the rate of growth and the quantity of money have been brought down, it has been brought down, and as a result inflation is lower today, in Britain, than it was shortly after Mrs. Thatcher came in. So on the subject of inflation she has been successful. But as in the United States, British monetary policy while not too bad on the average, has been terrible in its short time movements, it's been very erratic, as in the United States.

Kershaw And on the other three things?

Friedman On the other three things, let's go over them. Spending - tax cuts. Total Government taxes in Britain today are higher, as a fraction of national income, than they were the day Mrs. Thatcher came in. Number two: cutting Government spending. Total Government spending today is higher than the day Mrs. Thatcher came in, as a fraction of income, and that's true I believe. Even if you eliminate the special spending associated with unemployment. Number three: reducing Government involvement in the economy. There have been some successes there. Eliminating foreign exchange control was a major achievement of the Thatcher Government. I think there have been a few sell-offs of - you know better than I - of British nationalised enterprises, but in the main the Government continues to subsidise losing enterprises, it continues to maintain overblown nationalised industries. Those three planks have not been carried out. The result of not carrying them out is that the whole burden of disinflation fell on the private sector, and remember, the private sector in Britain is a lot smaller than it is in the United States, because Government in Britain is so much larger.

Kershaw — But hence you'd say that a lot of the high unemployment has been a direct cause of - directly caused by Government policy.

Friedman — Absolutely.

Kershaw — When I talked to you -

Friedman — Now let me emphasise. I am a great admirer of Mrs. Thatcher, I have not been in Britain for a year and a half or more, I do not know the obstacles which prevented Mrs. Thatcher from carrying out her policy, so I don't mean to be attributing blame to her. I rather suspect that more blame has to be attributed to two other factors. First, to the adamant opposition of the Civil Service, which is even more entrenched in Britain than it is here, to cuts in their expenditures; and second, to the fact that she does not have anything like uniform support within her own political Party, the Tory Party. Now I might note that in both of those respects the situation in the United States is much more favourable than in Britain.

Kershaw — Professor Friedman, I talked to you in Chicago five years ago, shortly after you'd won the Nobel Prize, and you there said, about Britain, and I quote - that there was a 50-50 chance that British democracy and freedom would be destroyed within the next five years. Well by chance we're at the end of those five years. What happened?

Friedman — Well fortunately the right 50 has so far come up, but the danger of the wrong 50 coming up is unfortunately not removed.

Kershaw — You still see it there?

Friedman — Very much so, unless Britain can carry out successfully the promises and the perfor - that Mrs. Thatcher made in her campaign. That is to say unless you can cut your Government down, and get it out of interfering as much as it has in industry, so that your people can go back to work, so you can have high employment, and relatively stable prices, unless you can achieve that objective, the danger and the loss of democracy and freedom I believe will remain.

Kershaw — Well you described - the words you used to me five years ago were that we were a desperately sick patient, do you still make the same diagnosis?

Friedman — Yes, you still are desperately sick. I think on the political side the prospects are perhaps a little better, because of the break-up of the Labour Party, and the emergence of Social Democrats, even though they have no coherent policy of their own. But on the economic side, it's clear that you are desperately sick. I don't see how one can use any other terms for that. What you have, that you did not have five years ago, is at least one coherent group, that has a well-designed, well-articulated programme for getting you out of the mess. But so far you haven't been able to carry that out.

Kershaw — I have to say it - the people who agree with you!

Friedman — Well no, the people who have read the past history the same way I have, I'm not - these aren't original observations from me. My God, you go back and read Adam Smith, of 1776, and all I'm doing is quoting him. And you know his predictions didn't turn out to be so bad.

Kershaw — But it does bring one to a basic question, Professor Friedman, that is economic tinkering, which is the word that Lenin used, is it really worth the social damage it creates? Because we have this fantastically high unemployment here -

Friedman — Of course not, no.

Kershaw — - with all those - all those strains.

Friedman — But what's tinkering? What the Governments before Margaret Thatcher did, was that tinkering? Or was that not tinkering? I'm against Government tinkering. What I am in favour of is not tinkering but dismantling. What I want to do is to get rid of Government tinkering. I think more harm has been done, far more harm has been done, socially and economically, by Government tinkering, than any amount of good that has ever been done.

Kershaw — I meant Governments fine-tuning the money supply, operating on the - on the basic structure.

Friedman — I'm not in favour of fine-tuning the money supply. All my life I have been opposed to fine-tuning the money supply. What I want to do is to set the money supply on a constant course and keep it there. For both Britain and the United States, what I have recommended all along, is that you try to move gradually to a level of money supply increase, which you can then maintain indefinitely, without changing, without tinkering, without fine-tuning.

Kershaw

Now unemployment is seen by most Western societies, at the moment, as the public enemy Number One. Not so much inflation, as it was a few years ago. Do you accept that unemployment is in itself a threat to stable societies?

Friedman

Of course it is, of course, long continued unemployment will destroy, almost surely, the stability and the freedom of any society. Nobody disagrees again with that, and the problem is one - it's wrong to base the argument on objectives, you have to look at means - how do you do it? The facts are that the major source of Western Europe's high level of unemployment, it's not only in Britain, it's also in Germany, it's also elsewhere on the continent, the major source of that high unemployment has been inflation. These are not two alternative public enemies. Inflation, per se, is not a public enemy, any more than a hammer that might hit you over the head is a public enemy. What's a public enemy is your getting hit over the head. And the reason inflation is bad is because it produces unemployment. It produces a misuse of resources, it produces an inequitable transfer of wealth from some people to the other. So that curing inflation is not a sufficient condition for eliminating unemployment, but it's a necessary condition for eliminating unemployment.

Kershaw

We've also been squeezing out what was called overmanning, people who've been held in jobs where perhaps they were getting uneconomic, but how can you persuade an unemployed man, a man who's just lost his job, that he's doing his bit by losing it?

Friedman

Oh I can't persuade him, from his point of view it's obviously a bad thing, but I don't really understand. What I want to know is how do I employ the person who is paying to keep an otherwise unemployed man in an uneconomic job? How do I employ - persuade that person that he should give that charity to the otherwise unemployed person? What you're calling for is a large act of charity, which is disguised under other terms, and in which the people who give the charity are never asked whether they're willing to do it. Now, the real answer to unemployment is that there shall be a environment, in which it is profitable for people to have a large number of alternative job openings, so that people can find a job; that's been the case over a long period. The major source of unemployment in our country, and in your country, is Government action, it's not the private economy.

Kershaw

Yes, but aren't there limits to pure economics, can I put it that way? You're an academic, and even if you're abstractly completely right, aren't there other constraints on politicians, which can make the policies you're suggesting unacceptable, that the politicians have to listen to the people more directly?

Friedman

Of course, of course there are other restraints on politicians, of course we live in a world which we hope is, and will continue to be, a democracy. And as long as it is a democracy the public will ultimately rule. And the public is by no means composed of people who either understand, or welcome pure economic reasoning. However, it's also true that beyond some point the combination of special interests, which impinge upon the politicians, will be so damaging to the public at large, that the public at large will wake up and exercise its influence on a broader level. And that is what's been happening in the United States. You have been having a general recognition that our greatest danger is an overblown, overgrown, cancerous growth in Government, and that general recognition was what produced last year the ability, on the part of Mr. Reagan, to get through his far-reaching programmes. In my opinion that same force is going to produce an even more far-reaching measure, which will be a constitutional amendment to limit Government spending, that's the next big sleeping issue.

Kershaw

But what about electorates, aren't they fickle too, because yes, when inflation was the great enemy they understood this business about controlling the money supply, tightening it up, but now unemployment's shot up, at least in our country people are saying - ah, let the brakes off, we must now - unemployment is the big enemy, back to Keynes.

Friedman

Of course the public is fickle, that is why we in - that's why the founders of this country decided to have a written Constitution, in order to preserve a more long run view of the situation, against the momentary shifts in public opinion. And that's why I think you will get very different answers from the public, according to the kind of question you ask them, or ask them to vote on. They will move one way, if you ask them to vote on current policy, but if you ask them to vote, as I hope we will - shall soon, in this country, on an amendment to the Federal Constitution, which would set long-term limits on Government spending, I think you'll get a wholly different answer. Because I think the bulk of the people, the bulk of the populace, is responsible, forward-looking, and will be in favour of measures which will work over a longer run, even though temporarily they'll depart from them. We're all that way.

Kershaw

Isn't that really just an ideological objection, or a gut rejection to Government - big Government is bad Government, Government is by nature bad? Government has to do a lot of things, doesn't it, in any society?

Friedman

Of course it does, but it's not - it's very much more than a gut reaction to the question, which I suggest you ask people. Something over - in the United States something over 40 percent of your income is paid - is going to pay for Government. In Britain it's well over 50 percent. Are you getting your money's worth? How many people do you think will say yes to that? Obviously Government has many responsibilities, and should carry them out, but the crucial test is whether we are getting our money's worth, for that fraction of our income which is being spent, supposedly on our behalf, by Government Civil Servants.

Kershaw Well you have the huge defence expenditure here, which the President -

Friedman The Defence expenditure -

Kershaw - is raising and raising again.

Friedman Excuse me, again get the facts straight. Defence expenditure, 10, 15 years ago, in the United States, before the Vietnam War, was something like 8 to 9 percent of our national income. It is currently about 5 percent of our national income. At the height of President Reagan's proposed build-up it will be 7 percent of the national income. Defence expenditures are not huge, what has happened in this country, as has happened in Britain, is that so-called welfare state expenditure - social security, entitlement programmes, all the other great society expenditures, have, for the past - for a while, were able to go up dramatically, while military expenditures went down. They went up at the expense of military expenditures, it's very difficult to reverse that.

Kershaw Let me stay with defence though. That is an expenditure which Government has to make -

Friedman Absolutely.

Kershaw It has to be Government that makes it, and B) it can make it inefficiently and waste money.

Friedman It does, unquestionably. I have no doubt that if you could figure some way of turning defence over to private enterprise, you could get a better defence for the United States for half the money, but although I've exercised my ingenuity trying to figure it, I haven't been able to figure out a way to do it. But of course it's wasted. But Government is by its nature wasteful, and that's why, in my opinion, we want to try to keep Government to do those things which only Government can do. What's happened, in my opinion, over the past 50, 75 years, is that Government has undertaken things which Government does very badly, and in the process has been unable to do the things that only Government can do. Look at the things only Government can do, only Government can defend us from our enemies, abroad, only Government can provide ultimate internal defence of ourselves from our fellows with police, and safely function. Has Government been performing those functions better or worse?

Kershaw Now critics of your theorism, particularly I think perhaps critics in Britain, would say that your reply will always be, if the policies don't work, they haven't been done long enough, let it go longer, or they haven't been done hard enough, let them be done harder. Is that fair comment?

Friedman

Well they haven't been done, period. Except for the monetary reduction, what has been done? Have taxes come down? Has spending come down? Has the Government done that with the private economy? I don't believe there's been any test in Britain of those policies at all, because they just simply have not been done.

Kershaw

Well finally Professor Friedman, let me ask you to crystal-ball gaze. How long do you think Mr. Reagan has got to get things right if your theories are going to be borne out? What is going to happen here in America?

Friedman

That depends very heavily on what the Independent Federal Reserve system does. The greatest threat to the success of President Reagan's programme, in my opinion, is the yo-yo monetary policy which the Federal Reserve has been following. If somehow or other that could be brought under control, I would say that within less than a year the United States will be on the path to a very healthy, long sustained, non-inflationary expansion.

Kershaw

And my own country, Great Britain?

Friedman

Your country's prognosis is not nearly as favourable, because you're in a much more desperate situation right now than we are, you have been so far less successful in carrying out any of the programmes necessary to get you out of that situation. But the situation is very far from bleak in the United Kingdom, there's a tremendous reservoir of able, enterprising, innovative people, in Britain. You have - the private sector, as I see it and understand it, has been able to get much more - much leaner and much more efficient, much more productive. Indeed it's fascinating to an outsider, that all of the major labour disputes have been with Government enterprises and nationalisation, than on the private sector side. The much feared obstacle of Trade Unions has not been an obstacle, to a more efficient organisation. So I think that the sort of process through which your private sector has gone has been healthy, though much too costly, much more costly than it need have been. And as a result I would not be surprised if, in the next two or three years, Britain experienced a rather significant economic revival. However, I don't believe you'll have any long-run success until you get to cut - until you cut your Government down to size.

Kershaw

Professor Friedman, thank you very much for talking to us.

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PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 8 February, are sidelined.

M M Deyes

M M DEYES

RIA

R I G ALLEN
15 February 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of forthcoming Budget.

4. Budget objectives

We intend to use the Budget to sustain and maintain the progress now evident. We shall continue with policies designed to reduce inflation and to create the conditions for sustainable growth.

5. Scope for tax cuts? Stimulation of economy?

Chancellor considers all representations. Cannot anticipate Budget judgement but no question of abandoning our strategy; cannot throw away gains already made. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

6. PM and Chancellor at odds over TUC proposals?

[Chancellor says 'responsible' PM says 'irresponsible']

Certainly not. My rhF commenting on TUC's approach; my remarks referred to their conclusions. (See also A26) The document certainly comprehensive and well presented. But solutions it offers are totally wrongheaded.

7. Armstrong report - TCSC comment from TCSC

[Report expected in the Spring]

Welcome interest shown by Treasury Select Committee in Armstrong report. Very important implications for conduct of Government bodies and for Parliamentary procedure. Shall look forward to Committee's report.

8. Endorse Armstrong recommendation?

Number of practical difficulties. Issues need further examination.

9. Government has failed to accommodate recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to 'buy' jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

10. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth in money GDP down from 17 per cent in 1980 to 10 per lending remains disturbingly high, particularly personal lending, despite the level of interest rates.

11. Why are high interest rates needed?

Current level of interest rates reflects both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 2 per cent since September.

12. Pressure on interest rates likely following President Reagan's Budget message?

[Budget message involved doubling of earlier $45 billion US deficit 1982: no new proposals to offset this by tax or spending changes]

everyone's interest that the US should defeat inflation. We know how difficult and painful the necessary decisions are. But concerned that the US deficit in 1982 wil be higher than earlier planned. Welcome the intention that it will decline in later years although deficits will remain large. As in all other countries, it is desirable that the US pursue balanced monetary and fiscal policies. This is crucial to interest rates - a matter that affects us all.

13. Chancellor Schmidt has introduced reflationary package?

Not so. Germany planned to reduce Government borrowing in 1982 by nearly 30 per cent. Unlikely the investment/employment scheme will entail significant effect (see also S7).

14. Expectations for UK economy in 1982 disappointing?

Further falls in inflation in prospect. Good export prospects and current balance will remain in surplus. Industry Act forecast shows 1 per cent growth in 1982. Appreciable progress made on improving competitiveness and productivity. Important to build on this. Recent report from CBI West Midlands ('Winning Through') illustrates way forward - companies have improved performance and diversified and developed products to capture new markets.

15. Recovery faltering?

[Industrial production in December down 1 per cent on November, 3 per cent on October]

Last quarter of 1981 production broadly same as Q3 and up from Q2.

16. Productivity bound to be 'improving' when 1¼ million laid off in manufacturing in past 2½ years?

No escaping fact that much of industry has been inefficient, overmanned. But does not follow that there has been permanent loss of jobs. Improved productivity/competitiveness enhances, not diminishes long-term prospect for jobs.

17. Unemployment in 1982?

The rate of rise in unemployment has slowed. Increase in recent months one third that at end 1980. This trend should continue. But clearly any firm forecasts for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects see C3].

18. Chancellor and some colleagues taking rosy view; Mr Pym's gloomier outlook nearer the truth?

Remarks have been quoted selectively from recent speeches by my various rt hon Friends. There is no logical discrepancy between what my rt hon Friends have been saying. They have drawn attention, as I have myself, to the accumulating indications of economic recovery. They have also warned that the soundly based reconstruction of our economy depends on keeping up the momentum of change in attitudes and practices.

19. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

20. Government has failed in objective of reducing burden of tax?

Burden has inevitably increased at time when national production not growing. But for vast majority real personal disposable income is still higher than for period of previous Government.

21. Inflation still higher than when Government took office?

True of the 12-month rate. But in May 1979 inflation was accelerating, on back of escalating wage settlements and increasing public sector prices. 12 month rate now broadly stable and set to resume downward movement later this year.

22. Labour Party reflationary programme?

[Mr Shore, 28 January Economic Debate, spoke of £6 billion reflation needed in 1982-83, over and above neutral Budget, to be 'no more and no less deflationary' than in 1981-82. Specific proposals include major attack on the unnecessarily high costs of British industry' through lower energy prices, lower exchange rates and a 'national understanding' on inflation; major investment in NIs and infrastructure; planning agreements and control over capital movements']

How can any such 'package' be credible when Mr Shore consistently backs away from costing it? He seems to have no fear of the extra borrowing that, he admits, would be necessary, nor of the cost in higher interest rates. And while he recognises the danger of inflation his proposals would involve, past experience of the social contract etc makes his idea of a 'national understanding' on pay and price scarcely credible. The package also threatens a return to planning agreements, control over capital movements and other bureaucratic nonsensities.

23. TUC Economic Review proposals?

[Annual Economic Review published 2 February calls for five-year strategy starting with £8.3 billion stimulus-extra public sector capital spending (£2.1 billion), social spending (£1.5 billion) and employment and training measures (£1.2 billion): suggests VAT cut equivalent to £2 billion: urges lower interest rates, orderly depreciation of sterling and quick-acting measure eg import controls, to protect trading position during first year of expansion. National Economic Assessment part of strategy.]

Macro-economic arithmetic unconvincing. Measures imply massive increase in inflation in medium term even if initial fall. National Economic Assessment idea reminiscent of former 'social contract' - and not likely to be of any more constructive use. Alleged employment effects not authenticated by TUC use of Treasury model because reflect TUC's own assumptions fed in.

24. TUC/Gilmour proposals tried out on Treasury economic model?

Computer models cannot be used in a mechanistic way. Results depend on assumptions. And, anyway, model relationships unlikely to hold eg for interest rates and exchange rates, for measures on scale proposed by TUC.

25 Sir Ian Gilmour points out HMT model says higher PSBR need not necessarily mean higher interest rates / PSBR self-financing ?

Treasury model can be operated in a number of ways : one option is to assume interest rates unchanged when PSBR rises. Effect on interest rates depends on market reaction-difficult to judge , impossible to model accurately. But not true model 'says' higher PSBR does not mean higher interest rates.(Depends on assumptions.) PSBR is not automatically financed by extra gilt sales ,either in real world or Treasury model.

26. CBI Budget proposals

[Reflationary package increasing PSBR to £11-12 billion in 1982-83; 2 per cent cut in NIS, limits on increases in local authority rates for businesses, lower interest rates]

Representations will be taken into account. Cannot anticipate Budget decisions. But rhF Chancellor will, in arriving at his Budget judgement, take full account of the circumstances facing the company sector.

27. Mrs Williams' prescriptions?

[Mild reflation with extra public investment in labour intensive programmes - Debate 27 January - claims would get 1 million off register in 2 years - 'Newsnight' 27 January]

Real answer to long term problems of British economy lies in greater productivity and more realistic pay bargaining, not more public employment. Rh Lady's assumption of an effective incomes policy is just wishful thinking.

(i) Signs of recovery

- Total output (GDP) rose by $^2/3$ per cent in 3Q 1981.
- Short time working in manufacturing fallen to 1/4 of January peak; total hours worked have been stable since beginning of 1981.
- Latest 1981 figures show volume of engineering and construction orders up about 18 and 10 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

(ii) Earnings and settlements. Increases halved in 1980-81 pay round. Public sector in line. There is a good deal of evidence that average settlements in private sector are running lower than in the 1980-81 round. [CBI pay data bank for manufacturing settlements suggests average is now around 7 per cent compared with 9 per cent in previous round.]

(iii) Productivity. Output per head in manufacturing in 1981 3Q 10 per cent higher than in 1980 4Q. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs in latest 12 months - up only 2 per cent in year to October.

(v) Competitiveness. Improved by over 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vi) Profits: Non North Sea industrial and commercial companies gross trading profits (net of stock appreciation) rose some 13 per cent in 3Q.

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. Engineering export orders up 22 per cent in 1981 on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and $^1/3$ that in 4Q 1980. Vacancies improving over recent months. Short-time working in manufacturing reduced by ¾ during 1981 and overtime working has increased. Total hours worked in manufacturing stable since Spring 1981.

(ix) Special employment measures. Total provision on Job Release Scheme, Temporary Short-Time Working Compensation and Community Enterprise Programme in 1982-83 now planned to reach over £520 million, with additional £61 million for young worker scheme (starting January 1982). Spending on Youth Opportunities Programme to rise to £700 million in 1982-83. 280,000 unemployed school-leavers last year found places on YOP by Christmas.

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.

(xiv) Loan Guarantee Scheme. Over 2300 guarantees issued so far on loans totalling over £80 million. Over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Examples of export successes reported in the Press include: £2½ million order to supply Leyland buses to Singapore; £3 million worth of equipment for the King Abdullah Aziz Military Academy in Saudi Arabia (SGB); £4 million worth of outside broadcasting vehicles and transmitters for Nigerian Television (PYE TV Ltd); £23 million worth of defence communications equipment for Austria (Racal jointly with Austrian counterparts); £20 million worth of power station pipework for Australia (Whessoe).

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Current position and prospects?

[NB Q4 capital expenditure and stocks of manufacturers and distributors to be released Thursday 18 February. Q4 GDP (output) estimate to be released on Friday 19 February.]

Fall in output over. GDP (output), on latest figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2 with manufacturing and construction output up some 2 per cent in same period. Rate of destocking sharply cut. Industry Act Forecast - supported by most outside forecasts (see B5 and 6) - sees prospect of recovery during 1982.

2. Other evidence of improvement in economy?

Net new construction orders in 1981 up 9 per cent on H2 1980. Net new engineering orders 17 per cent; within this, export orders up 21 per cent in same period. Private housing starts for 1981 37 per cent up on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980.

December cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November and December.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

3. Recent manufacturing production figures show resumed decline?

[Manufacturing output in November and December down some 2 per cent in each month with December figure reaching new low point.]

November and December figures affected by car disputes and exceptionally severe weather. Even so, index for Q4 as a whole much the same as in Q3, and about 1 per cent higher than in Q2.

4. Latest CBI Industrial Trends Survey shows prospects gloomy?

[January survey widely mis-quoted in Press as showing gloomy prospects - in the main based on Sir Terence Beckett's comments].

In judging the latest survey must look at survey itself. Survey shows an improvement in optimism and the expectation of some rise in the volume of orders and output, especially for exports, in the next four months. Much the same message is given by latest FT survey. The CBI's commentary draws attention to improving trends in profitability, investment intentions and productivity.

5. Government assessment of prospects

[Industry Act forecast (2 December) assessed recovery to have begun. End to destocking. Consumers' expenditure and Government expenditure flat.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

NB New assessment will be contained in FSBR to be published with Budget]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR	LBS	CBI	Phillips & Drew	OECD	IAF
	(Nov)	(Nov)	(Nov)	(Feb)	(Dec)	(Dec)
Per cent change 1982 on 1981	+½	+1¾	+1	+1	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic, seeing recovery delayed into 1983. ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

7. High interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

C LABOUR

1. Unemployment continues to rise?

[January total count was 3,071,000 (12.7 per cent). Seasonally adjusted excluding school leavers figure was 2,829,000 (11.7 per cent).]

Magnitude of January rise reflects, in addition to normal seasonal increase, abnormally severe weather. Underlying rate continues to rise much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut - (down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised. Vacancies continue to improve: both in total available and rate of new ones being notified.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment fell back 32,000 a month in three months to November, compared with 50,000 a month earlier in 1981.).]

Third quarter decline in total employment half that in H1 1981. Manufacturing employment statistics show lower rate of decrease was maintained into fourth quarter.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). Reflected in wider range especially for beyond 1982.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Yes, but it has reached record levels in a number of other industrial countries. Most OECD countries have seen steeper rises than Britain in the last few months; in France, despite President Mitterand's expansionist policies, it has gone over 2 million; in Germany it has reached 1.7 million, the highest figure since the early post-war period. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to public funds to the current level of unemployment?

[Subject of an oral PQ to a Treasury Minister 11 February and of CST speech at Guisborough 5 February]

Payments of unemployment benefit and supplementary benefit to people registered as unemployed are expected to total about £4 billion in 1981-82. Comparable figures cannot be given for revenues which were not collected - such figures could only be hypothetical.

7. Total cost of unemployment £13 billion?

Totals of this kind are by themselves meaningless. They imply a comparison with an economy with zero unemployment which is not feasible. A really major change in the level of unemployment would mean that taxes, benefits, wages, prices etc would be very different from the present. £13 billion is not a 'cost' which could be saved or spent elsewhere. We cannot wish unemployment away.

8. Why not employ unemployed people on public works etc?

['Layard' scheme; S Brittan in FT 11 February]

We continue to examine the options. But schemes to provide public jobs inevitably have a net public expenditure cost. Since schemes are not costless the need to finance them is likely to lead to some reduction in employment elsewhere. We are, of course, spending money where circumstances justify this (see 9-12 below). Balance of public finances complex and figures depend on particular measures. Other elements as well as benefit savings and tax receipts. If jobs are in public sector there are wages and perhaps other expenses (supervision, costs of materials). If jobs in private sector, any subsidy would be an expenditure.

9. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 increased to over £520 million, with additional £61 million for young worker scheme starting on 6 January 1982. New Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be some £1½ billion - almost £800 million more than in last Public Spending White Paper (revalued).

10. Need to bring system of industrial training up to date?

Agreed. White Paper 'New Training Initiative' sets out action required in industry and education as well as lead from Government. New Youth Training Scheme will guarantee full year's foundation training to those leaving school at minimum age. Government objective that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. 'Open Tech' programme being developed to make technical training available to those with ability to benefit.

11. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

12. What has Government done to make labour market more flexible?

Have taken action on a number of points:

Training: extra spending on 16-17 year olds plans to reform apprenticeship system (see C9 above).

Young workers: subsidy to employers to take on youngsters at lower wage rates - object to price young back into labour market.

Mobility: Housing Act 1980 provisions for short-term tenancy in private rented sector.

Industrial relations: steps already taken and further proposals just published to redress imbalance of power between employers and unions.

Employment Act 1980 measures to reduce costs of employment and rigidity in wage-setting practices.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. Not worse than in other countries?

Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

3. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in 2 December statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. (See G5.) Other factors will also be important, including monetary targets and outlook for pay and inflation.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Distribution of incomes became more unequal between 1976 and 1980?

[CSO figures on income distribution in January Economic Trends reported in The Times 9 February]

True - but not as a result of unemployment. Many of the unemployed came from families with two or more earners, and were therefore high on the scale of household incomes before the loss of one income. Unemployment may therefore have caused a reduction in inequality. Important factor the increase in number of retired people.

6. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

7. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be of help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

8. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982).

9. The burden of corporation tax is too high/not high enough?

The Green Paper shows that the burden of corporation tax has more or less matched changes in company profitability. The question of appropriate burden of corporation tax is not covered in the Green Paper but will be considered by my rhF in reaching his Budget decisions.

10. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

11. North Sea fiscal regime?

See R2-3.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

5. Further reductions possible in 1982-83?

[CBI's 'Winning Budget' suggests further savings possible - in 1982-83 £100 million in manpower costs, £700 million from reduced total for contingency reserve, shortfall, asset sales and interest payments]

Further savings in manpower not feasible. Plans take account of savings in administrative costs and reduction of manpower. 4 per cent provided for increases in public sector pay next year (see E12 and 13). Government considering question of index-linking of and contributions to public service pensions (see J15). Figures for contingency reserve, asset sales and interest payments must be realistic.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

8. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

9. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with the cash equivalent of the last White Paper, but recent fall in tender prices will mean the programmes should be carried out as planned.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Government overspending by £1,250 million?

[D Blake in The Times 27 January.]

My rhF's statement 2 December gave global adjustment of £3,300 million in arriving at total of £115 billion. Statement explained clearly that the £3,300 million included not only the contingency reserve [NOT FOR USE: not then decided] but also allowance for the effect on programmes [notably social security, housing and export credit guarantees] of revised economic assumptions.

12. Cash limits 1982-83 and public sector pay?

[Leader 'Who Guards the Guardians?' in The Times 4 February]

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Recent evidence given to the Megaw Inquiry on Civil Service pay simply described, at the Inquiry's request, existing mechanisms for dealing with public expenditure including public service pay. Negotiations on the pay of those public services for which central Government is directly responsible have yet to take place. Offers have yet to be made and settlements have yet to be reached. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged.

13. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made.

14. Contingency reserve and pay

Existence of Contingency Reserve does not mean that excessive public service pay settlements will be financed. If a pay increase is justified and cannot be financed within cash limits or by savings elsewhere, access to Reserve is possible. This is a decision which Ministers would have to take at the appropriate time, bearing in mind other potential calls on the reserve. Government's view remains that 4 per cent is a reasonable overall provision within its expenditure planning.

15. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

16. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by nearly 8 per cent to 675,400. This is smallest for nearly 15 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 75,000 (over 4 per cent).

17. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

18. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

19. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

20. Will the Government limit rates as suggested by the CBI?

We certainly share the CBI's concern about the harmful effect of high rates on business. The problem with limiting rates is that, unless local authorities cut their spending, it has to be paid for by domestic ratepayers or the taxpayer generally. However, we will be considering this further in the context of the longer term future of the domestic rating system. Meanwhile the Government's continuing pressure on local authorities to reduce expenditure will help all ratepayers.

21. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

22. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

F SOCIAL SECURITY

1. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

2. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

3. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April/July 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

4. Death grant - increase to realistic level?

We recognise that the present death grant of £30 is of only marginal benefit, and have been looking at ways in which it could be improved. I hope there will be an announcement on this soon.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast showed PSBR in 1981-82 on target for Budget estimate of £10½ billion; PSBR in April - December published 4 February was £10¾ billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion. Despite the strike, the PSBR for April-December was only £10¾ billion. PSBR for 1980-81 as a whole was £13¼ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CONFIDENTIAL: CGBR April-January to be published 9 February, was £8 billion.]

Effect of dispute (concluded July 1981) was to add around £2¼-2½ billion to the CGBR in April 1981-January 1982, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's 1981 Budget statement he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 16 per cent in September, fell to 14½ per cent in December, and were reduced by the clearing banks to 14 per cent with effect from 25 January. Market rates were firm in early part of January, in particular reflecting increases in US market rates. In second half of January and early February, interest rates generally fell back and have remained at or around these lower levels.]

Of course we want to see lower rates. But we must proceed cautiously if we are not to let up in the fight against inflation. Despite difficult conditions abroad, interest rates have fallen.

2. Will high US rates push up our rates?

High US rates are certainly an adverse development and in September were one of the key factors in driving our rates up. Recently, however, with the pound remaining stable in world markets, our rates have been able to ease somewhat, without creating inflationary dangers. The position of the pound has no doubt been helped by better prospects for the wage round and the good trade figures. Nevertheless, it remains true that domestic policy cannot ignore the difficult international background.

3. What is the Government doing about it?

As my rhF the Chancellor stated in his speech to the House of 28 January, we support the anti-inflationary stand of the US authorities. But we have made clear on many occasions our concern about the balance of fiscal and monetary policy and its implications for interest rates.

4. If US rates are determining ours, why all the concern about the PSBR?

We do not claim that US rates are sole influence on our own and that there is nothing we can do to offset our own rates. Just as we are urging a balance between fiscal and monetary policy in the US, so we must achieve that ourselves.

5. Should not European governments jointly exert pressure on US?

Other European governments have made their views known in the same way we have.

6. Interest rates levels choking the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

7. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

8. Will there be an overshoot of money supply?

[£M3 increased by 1½ to 1¾ per cent in banking January. Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high, despite the level of interest rates.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) January. In ten months ending January the effect of the strike was to add around £2½-2½ billion to the CGBR.

10. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

11. Plans for modifying MTFS?

Government's economic policy has evolved and developed since we have been in office -and no doubt will continue to do so - but the aims of our medium term strategy are still precisely those set out in the 1980 Budget Report - to reduce inflation and thereby create the conditions for sustained growth in output and employment. My rhF the Chancellor intends to present an updated MTFS in the forthcoming Budget.

12. What was purpose of new guidance issued to banks on mortgage lending?

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

13. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in January.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in January at 12 per cent, compared with lowest recent level of 10.9 per cent in July 1981.]

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Industry Act forecast is for year-on-year rate of inflation of 10 per cent by Q4 1982. We expect downward trend to continue thereafter. [IF PRESSED: Precise timing of further progress is of course uncertain. Could be before the end of the year, could be early next year.]

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P11-12.]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less; some more. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurances they were given last year about this year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals have accepted offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. LA manuals' settlement higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[Miners have accepted offer worth 9.3 per cent on basic rates [NOT TO BE QUOTED: 7.4 per cent on earnings]; water manuals have accepted offer worth 9.1 per cent on rates, (8.8 per cent on earnings)].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. Private sector pay - CBI claim most settlements for 4-6 per cent?

[In a recent press release, the CBI asserted that the bulk of manufacturing settlements monitored since 1 August were in the 4-6 per cent range. But their own CONFIDENTIAL evidence shows a weighted average of 7.3 per cent with majority of employees over 7 per cent.]

There is no doubt that settlements have been lower in recent months, reflecting an increasing sense of realism about pay. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3 1981.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Decrease in year on year growth from 11.9 per cent in October to 11.3 per cent in November. However, (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to November straddles two pay rounds - not useful indicator of recent trends.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Incomes Policy

[Attention may be drawn to Prof. Meade's proposal in his book "Stagflation Vol I" (published 21 January) for an incomes policy, based on consensus about growth of aggregate national income, and featuring arbitration on employment - effect criteria; or to Prof. Layard's ideas for wage inflation tax (picked up by SDP).]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

The Government is considering the whole question in the light of the Scott Report. Our aim is to ensure that pensions to public servants are fair to taxpayers, as well as to employees, pensioners and their dependents.

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

December current account is estimated to have been £498 million in surplus, compared with £218 million in November. Most of the improvement was due to increased surplus on oil and erratic goods. Although both exports and imports fell back from the high November levels, these figures confirm the underlying recovery in UK trade.

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

Surplus on oil exports rose by £188 million to £402 million. Trade in erratics (precious stones, aircraft, ships, North Sea installations) improved by £86 million. This reflects recent trend towards surplus in ships and aircraft, consistent with UK manufacturers' general success in exporting finished capital goods.

4. Trends in imports

December import figures are in line with the average for the previous 3 months. The recovery in imports is across the board, including basic materials and manufactures used by UK industry. This supports the view that destocking is coming to an end and the economy picking up.

5. Trends in invisibles

Surplus on all invisibles is projected to be around £500 million in Q4 1981.

6. TUC proposal for an import deposit scheme?

[TUC Economic Review published 2 February]

This would raise prices in the shops, increase costs for domestic manufacturers, run counter to our international obligations and probably lead to retaliation against successful British exporters.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective note peak early last year. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. "Highs" were $1.97 on 30 November, DM4.40 on 9 February. Rates at noon on 12 February were $1.8387; DM4.38 and an effective rate of 91.52. Reserves at end January stood at $23.2 billion, compared with $23.3 billion at end December]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Concerted intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

4. Does the Government have an exchange rate target?

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

5. Sterling should join the EMS?

[See M8]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to \$14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only \$13.3 billion, compared with over \$22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

On 25 January, Foreign Ministers had a lengthy discussion on the four key issues in the negotiations over the Mandate. It was not possible to reach agreement. The main issue preventing agreement was the view of a number of other Member States that refunds to the UK should be arbitrarily and automatically reduced over time, regardless of the scale of the problem. That was quite unacceptable to the UK. There was also disagreement about the duration of the new refunds arrangement. The Presidents of the Council and Commission are now to try to find solutions to these problems.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May 1980.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

The most recent Commission estimates suggest that our net contributions in respect of 1980 and 1981 will be significantly lower than expected at the time of the 30 May Agreement. That is very satisfactory. For we remain one of the less prosperous Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

[FT 1 February alleged Government hardening against participating in exchange rate system.]

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies. Clearly there is a balance of advantages, risks and disadvantages to be struck - which must affect our judgement on timing.

N INDUSTRY

1. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output broadly same in Q3 as Q4 1981. Autumn Industry Forecast sees recovery in 1982.

2. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging. Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

3. High interest rates damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

SMALL FIRMS

4. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

5. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2300 guarantees - well over half to new businesses. Total lending under scheme is already over £80 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

6. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

7. Response from private sector?

Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although we now expect the final figure

to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published last August estimated in range of £250-500 million this financial year.

6. Future years?

Investment approvals will be published in the forthcoming Public Expenditure White Paper, as in previous years.

7. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries in aggregate should be more than able to maintain the same level of investment in 1982-83 planned in the last White Paper, despite lower revenues, with higher investment in important industrial priorities, eg telecommunications. This would represent the highest real level of investment in the industries since 1975-76.

8. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

9. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

10. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

11. Nationalised industries' prices

[Caution: gap between NI and 'all items' RPI index could widen again in near future. Factors include LT fare increases in spring, winter electricity discount scheme ending, dropping out of index of last year's double revalorisation of excise duties.]

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. But since the middle of 1980-81 the gap between industry price increases and the RPI has started to narrow sharply. Alternative policies would result in an unacceptable increased burden on taxpayer and distortion of market forces.

12. Will HMG take action over electricity price rises to large users?

The review by the Electricity Council of the CEGB's Bulk Supply Tariff has now been produced and is currently being considered by Ministers.

PRIVATISATION

13. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

14. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. The Government expect to have sold shares in the National Freight Corporation by end of this financial year. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Will HMG reduce price of North Sea oil further in face of weak market?

[BNOC have agreed $1.50 reduction* with BP - negotiations continuing with other companies].

UK continental shelf prices are set by commercial negotiation. BNOC is largely a third party trader, and must find prices which satisfy both suppliers and customers.

2. Impact of falling oil prices on Government revenues and Government strategy?

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. (New forecasts of Government revenues will be published at Budget time). But note that falling oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation. On balance, despite lower revenues, UK should benefit.

3. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute for Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

4. Does HMG accept C&AG's criticisms of the North Sea fiscal regime?

A full review of the fiscal regime is in progress. We shall take the C&AG's observations into account.

5. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

6. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level

*Means 4 per cent reduction in price of Forties oil - effect in sterling terms will vary from this with fluctuations in exchange rate.

of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

7. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

8. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

9. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The proposed sale of 51 per cent of BNOC's upstream business means that an oil bond is no longer necessary.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9¾ per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9¾ per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits. [For US , see 9 below]

5. Other countries giving priority to reducing unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. UK is alone in Europe. Even Germany announced investment/employment scheme last week?

No. Germany planned to reduce Government Borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

8. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasts expect UK growth this year of about 1 per cent. This is broadly in line with the OECD's forecast for our major industrial competitors. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

9. Even US using fiscal deficit to stimulate economy?

True US deficit is larger than anticipated. It is planned to fall but present level carries risk of prolonging period of high interest rates which could delay a European recovery. We strongly support the determination of the US authorities to combat inflation. But we believe fiscal and monetary policies must work together to that goal.

10. Recent international interest rate developments?

True that US interest rates have risen again in recent weeks. Prime rates are well below their peak of 21½ per cent last summer.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY   15 February 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The Industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In Q4 1981 industrial output rose ½ per cent while manufacturing output was little different from the previous quarter.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales fell back in December 1981 but the average level in Q4 1981 rose ½ per cent. The volume of visible exports in Q4 1981 was 5½ per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,829,000 (11.7 per cent) at January count, up 47,000 on December. Vacancies rose 6,700 to 114,200 in January.

Wholesale input prices (fuel and materials) rose ¾ per cent in January; however the year-on-year increase fell to 13¾ per cent. Wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 11.3 per cent in November. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.7 bn in the first three quarters of 1981/82 and CGBR (unadjusted) £8.0 bn in ten months to January 1982; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 1½ to 1¾ per cent in banking January.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-January $23.2 bn. At the close 12 February the sterling exchange rate fell to $1.84 but the effective rate remained at 91.6.

PPS/CHANCELLOR

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copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
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PS/Lord President of the Council
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PS/Secretary of State for the Environment
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PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 1 February, are sidelined. Briefing related to President Reagan's Budget message is at A11,H4,S10 .

M M Deyes

M M DEYES

RA

R I G ALLEN

8 February 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of 1982 Budget.

4. Budget objectives

We intend to use the Budget to sustain and maintain the progress now evident. We shall continue with policies designed to reduce inflation and to create the conditions for sustainable growth.

5. Scope for tax cuts? Stimulation of economy?

[FTS February sees scope for £1 billion in light of PSBR position; Chancellor saw CBI 2 February; will see TUC 10 February]

Chancellor will consider all representations. Cannot anticipate Budget judgement but no question of abandoning our strategy; cannot throw away gains already made. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

6. Armstrong report - TCSC comment

[Discussion at hearing on 25 January.]

Welcome interest shown by Treasury Select Committee in Armstrong report. Very important implications for conduct of Government bodies and for Parliamentary procedure. Shall look forward to Committee's report.

7. Endorse Armstrong recommendation?

Number of practical difficulties. Issues need further examination.

8. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

9. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth in money GDP down from 17 per cent in 1980 to 10 per cent in 1981. Inflation rate halved since spring 1981 peak. Some good features in monetary picture - outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

10. Why are high interest rates needed?

Current level of interest rates has reflected both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 2 per cent since September.

11. Pressure on interest rates likely following President Reagan's Budget message?

[Budget message involves doubling of earlier $45 billion US deficit 1982: no new proposals to offset this by tax or spending changes]

I am concerned that the US deficit in 1982 will be higher than earlier planned. I welcome the intention that it will decline in later years. Full assessment must, clearly, await release next month of precise budgetary arithmetic. As in all other countries, it is desirable that the US pursue balanced monetary and fiscal policies - this is crucial to interest rates. It is in everyone's interest that the US should defeat inflation. We know how difficult and painful the necessary decisions are. [See also Section H and S]

12. Chancellor Schmidt has introduced reflationary package?

(See S7).

13. Expectations for UK economy in 1982 disappointing?

[Sir Terence Beckett: "I have no evidence that a recovery is under way, all that one can say is that it's stopped falling". See B5 for details of December Industry Act Forecast. New forecast will be published with Budget]

Further falls in inflation in prospect. Good export prospects and current balance will remain in surplus. Industry Act forecast shows 1 per cent growth in 1982. Appreciable progress made on improving competitiveness and productivity. Important to build on this. Recent report from CBI West Midlands illustrates way forward - companies have improved performance and diversified and developed products to capture new markets.

14. Productivity bound to be 'improving' when 1¼ million laid off in manufacturing in past 2½ years?

No escaping fact that much of industry has been inefficient, overmanned. But does not follow thtat there has been permanent loss of jobs. Improved productivity/competitiveness enhances, not diminishes long-term prospect for jobs.

15. Unemployment in 1982?

The rate of rise in unemployment has slowed. This trend should continue. But clearly any firm forecasts for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects see C3].

16. Chancellor and some colleagues taking rosy view; Mr Pym's gloomier outlook nearer the truth?

[Mr Pym 1.2.82 'We are committed to a long term economic recovery that can be sustained and a restoration of our ability to complete .... this cannot lead to an early return to full or nearly full employment, or an early improvement in living standards generally'.

Mr Tebbit 9.11.81 'We shall not see a sustained fall in unemployment until economic recovery is firmly established, until we are winning back customers we have lost to other countries'.

Chancellor 2.12.81 OR col.245. 'It is inevitable that there must be some reduction in personal living standards if we are to accumulate resources for further investment and for a further reduction in unemployment'.]

Remarks have been quoted selectively from recent speeches by my various rt hon Friends. There is no logical discrepancy between what my rt hon Friends have been saying. They have drawn attention, as I have myself, to the accumulating indications of economic recovery. They have also warned that the soundly based reconstruction of our economy, which alone can bring sustained improvements in employment and living standards, is not to be regarded as 'in the bag', without further effort. It depends on keeping up the momentum of changed attitudes and practices.

17. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

18. Government has failed in objective of reducing burden of tax?

Burden has inevitably increased at time when national production not growing. But for vast majority real personal disposable income is still higher than for period of previous Government.

19. Inflation still higher than when Government took office?

True of the 12-month rate. But in May 1979 inflation was accelerating, on back of escalating wage settlements and increasing public sector prices. 12 month rate now broadly stable and set to resume downward movement later this year.

20. Alternative courses?

(a) Labour Party reflationary programme?

[Mr Shore, 28 January Economic Debate, spoke of £6 billion reflation needed in 1982-83, over and above neutral Budget, to be "no more and no less deflationary" than in 1981-82. Specific proposals include "major attack on the unnecessarily high costs of British industry" through lower energy prices, lower exchange rates and a "national understanding" on inflation; major investment in NIs and infrastructure; planning agreements and "control over capital movements"]

How can any such 'package' be ~~creditable~~ credible when Mr Shore consistently backs away from costing it? He seems to have no fear of the extra borrowing that, he admits, would be necessary, nor of the cost in higher interest rates. And while he recognises "the danger of inflation" his proposals would involve, past exp~~ansion~~erience of the "social contract" etc makes his idea of a "~~neutral~~ national understanding" on pay and price scarcely ~~creditable.~~ credible The package also threatens a return to planning agreements, control over capital movements and other bureaucratic nonsensities.

(b) TUC Economic Review proposals?

[Annual Economic Review published 2 February calls for five-year strategy starting with £8.3 billion stimulus-extra public sector capital spending (£2.1 billion), social spending (£1.5 billion) and employment and training measures (£1.2 billion): suggests VAT cut equivalent to £2 billion: urges lower interest rates, orderly depreciation of sterling and quick-acting measure eg import controls, to protect trading position during first year of expansion. National Economic Assessment part of strategy.]

Macro-economic arithmetic unconvincing. Measures imply massive increase in inflation in medium term even if initial fall. National Economic Assessment idea reminiscent of former 'social contract' - and not likely to be of any more constructive use. Alleged employment effects not authenticated by TUC use of Treasury model because reflect TUC's own assumptions fed in.

(c) CBI Budget proposals

[Reflationary package increasing PSBR to £11-12 billion in 1982-83; 2 per cent cut in NIS, limits on increases in local authority rates for businesses, lower interest rates]

Representations will be taken into account. Cannot anticipate Budget decisions.

BULL POINTS   As at 8.2.82 (Tape 455)

(i) Signs of recovery

- Total output (GDP) rose by $^{2}/3$ per cent in 3Q 1981.
- Manufacturing and construction output up about 2½ per cent between 2Q and 3Q. Latest figures for manufacturing show improvement maintained.
- Short time working in manufacturing fallen to 1/4 of January peak; total hours worked have been stable since beginning of 1981.
- 3Q figures show rate of destocking reduced by 4/5 compared with 1H 1981.
- Latest 1981 figures show volume of engineering and construction orders up about 18 and 10 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

(ii) Earnings and settlements. Increases halved in 1980-81 pay round. Public sector in line. CBI pay data bank for manufacturing settlements shows bulk of settlements in current round in 4-6 per cent range compared with 7-9 per cent in same period of previous round.

(iii) Productivity. Output per head in manufacturing in 1981 3Q 10 per cent higher than in 1980 4Q. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs in latest 12 months - up only 2 per cent in year to October.

(v) Competitiveness. Improved by over 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vi) Profits: Non North Sea industrial and commercial companies gross trading profits (net of stock appreciation) rose some 13 per cent in 3Q.

(vIi) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and $^{1}/3$ that in 4Q 1980. Vacancies improving over recent months. Short-time working in manufacturing reduced by ¾ during 1981 and overtime working has increased. Total hours worked in manufacturing stable since Spring 1981.

(ix) Special employment measures. Total provision on Job Release Scheme, Temporary Short-Time Working Compensation and Community Enterprise Programme in 1982-83 now planned to reach over £520 million, with additional £61 million for young worker scheme (starting January 1982). Spending on Youth Opportunities Programme to rise to £700 million in 1982-83. 280,000 unemployed school-leavers last year found places on YOP by Christmas.

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in December of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.

(xiv) Loan Guarantee Scheme. Over 1800 guarantees issued so far on loans totalling over £63 million. Over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Export orders in engineering up to 40 per cent in three months to October. Examples of successes reported in the Press include: £2½ million order to supply Leyland buses to Singapore; £3 million worth of equipment for the King Abdullah Aziz Military Academy in Saudi Arabia (SGB); £4 million worth of outside broadcasting vehicles and transmitters for Nigerian Television (PYE TV Ltd); £23 million worth of defence communications equipment for Austria (Racal jointly with Austrian counterparts); £20 million worth of power station pipework for Australia (Whessoe).

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

Economic Briefing Division, HM Treasury, 01-233 3364/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Latest information on output, production and stocks - recession over?

Fall in output now over. GDP output on latest - revised - figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2. Manufacturing and construction output increased by some 2 per cent in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking one-third that of H1 1981.

2. Latest CBI Industrial Trends Survey shows prospects gloomy?

[January survey widely mis-quoted in Press as showing gloomy prospects - in the main based on Sir Terence Beckett's comments].

In judging the latest survey must look at survey itself. Survey shows an improvement in optimism and the expectation of some rise in the volume of orders and output, especially for exports, in the next four months. Much the same message is given by latest FT survey. The CBI's commentary draws attention to improving trends in profitability, investment intentions and productivity.

3. Latest industrial production figures show rise in output faltering?

[Industrial and manufacturing output in November both down 1½ per cent in November, though up 1½ and 1 per cent respectively in 3 months to November compared previous three.]

Bound to be monthly fluctuations: fall in November due in part to BL and Ford disputes. Allowing for these, November index remained somewhat above its September level.

4. Other evidence of improvement in economy?

Latest (November) figures show net new construction orders in 1981 up 9 per cent on H2 1980. Net new engineering orders 18 per cent; within this, export orders up 21 per cent in same period. Private housing starts for 1981 as a whole 37 per cent up on H2 1980. Latest (December) figures for retail sales up 2 per cent between 1980 and 1981. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980.

December cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November and December.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

5. Government assessment of prospects

[Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat. NB Next Industry Act forecast will be published with Budget]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR	LBS	CBI	Phillips & Drew	OECD	IAF
	(Nov)	(Nov)	(Nov)	(Feb)	(Jan)	(Dec)
Per cent change 1982 on 1981	+½	+1¾	+1	+1	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic, seeing recovery delayed into 1983. ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

7. High interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

C LABOUR

1. Unemployment continues to rise?

[January total count was 3,071,000 (12.7 per cent). Seasonally adjusted excluding school leavers figure was 2,829,000 (11.7 per cent).]

Magnitude of January rise reflects, in addition to normal seasonal increase, abnormally severe weather. Underlying rate continues to rise much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut - (down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised. Vacancies continue to improve: both in total available and rate of new ones being notified.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment fell back 32,000 a month in three months to November, compared with 50,000 a month earlier in 1981.).]

Third quarter decline in total employment half that in H1 1981. Manufacturing employment statistics show lower rate of decrease was maintained into fourth quarter.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). Reflected in wider range especially for beyond 1982.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Yes, but it has reached record levels in a number of other industrial countries. Most OECD countries have seen steeper rises than Britain in the last few months; in France, despite President Mitterand's expansionist policies, it has gone over 2 million; in Germany it has reached 1.7 million, the highest figure since the early post-war period. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to public funds to the current level of unemployment?

/ Subject of an oral PQ to a Treasury Minister 11 February /

Payments of unemployment benefit and supplementary benefit to people registered as unemployed are expected to total about £4 billion in 1981-82. Comparable figures cannot be given for revenues which were not collected - such figures could only be hypothetical.

7. Total cost of unemployment £13 billion?

Totals of this kind are by themselves meaningless. They imply a comparison with an economy with zero unemployment which is not feasible. A really major change in the level of unemployment would mean that taxes, benefits, wages, prices etc would be very different from the present. £13 billion is not a "cost" which could be saved or spent elsewhere. We cannot wish unemployment away.

8. Why not employ unemployed people on public works etc?

We continue to examine the options. But schemes to provide public jobs inevitably have a net public expenditure cost. since schemes are not costless the need to finance them is likely to lead to some reduction in employment elsewhere. We are, of course, spending money where circumstances justify this. Balance of public finances complex and figures depend on particular measures. Other elements as well as benefit savings and tax receipts.

If jobs are in public sector there are wages and perhaps other expenses (supervision, costs of materials). If jobs in private sector, any subsidy would be an expenditure.

9. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 increased to over £520 million, with additional £61 million for young worker scheme starting on 6 January 1982. New Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be some £1½ billion - almost £800 million more than in last Public Spending White Paper (revalued).

10. Need to bring system of industrial training up to date?

Agreed. White Paper 'New Training Initiative' sets out action required in industry and education as well as lead from Government. New Youth Training Scheme will guarantee full year's foundation training to those leaving school at minimum age. Government objective that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. 'Open Tech' programme being developed to make technical training available to those with ability to benefit.

11. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

12. What has Government done to make labour market more flexible?

Have taken action on a number of points:

Training: extra spending on 16-17 year olds plans to reform apprenticeship system (see C9 above).

Young workers: subsidy to employers to take on youngsters at lower wage rates - object to price young back into labour market.

Mobility: Housing Act 1980 provisions for short-term tenancy in private rented sector.

Industrial relations: steps already taken and further proposals just published to redress imbalance of power between employers and unions.

Employment Act 1980 measures to reduce costs of employment and rigidity in wage-setting practices.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. Not worse than in other countries?

Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

3. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in 2 December statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. (See G5.) Other factors will also be important, including monetary targets and outlook for pay and inflation.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Reduce National Insurance Surcharge?

[Major element in CBI Budget representations to be published 10 February

Well aware of view of many in industry that a reduction in NIS would be of help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

6. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

7. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

8. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982).

9. The burden of corporation tax is too high/not high enough?

The Green Paper shows that the burden of corporation tax has more or less matched changes in company profitability. The question of appropriate burden of corporation tax is not covered in the Green Paper but will be considered by my rhF in reaching his Budget decisions.

10. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

11. North Sea fiscal regime?

See R2-3.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

[Outturn for current year expected to be in region of £107 billion against £105 billion (revalued and adjusted) in last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring; changes in circumstances could well lead to higher or lower total than £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

5. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. <u>Increase spending on worthwhile infrastructure projects</u>?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

8. <u>Cuts in public capital investment in 1982-83</u>?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with the cash equivalent of the last White Paper, but keen tendering will mean the programmes should be carried out as planned.

9. <u>Number of cash limits breached last year</u>?

[Full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as White Paper (Cmnd 8437) on 4 December.]

In aggregate, central government voted cash limits in 1980-81 were <u>underspent</u> by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal.

10. <u>Position on 1981-82 cash limits</u>?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure <u>overall</u> is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. <u>Government overspending by £1,250 million</u>?

[D Blake in <u>The Times</u> 27 January.]

My rhF's statement 2 December gave global adjustment of £3,300 million in arriving at total of £115 billion. Statement explained clearly that the £3,300 million included not only the contingency reserve [NOT FOR USE: not then decided] but also allowance for the effect on programmes [notably social security, housing and export credit guarantees] of revised economic assumptions.

12. Cast limits 1982-83 and public sector pay?

[Leader 'Who Guards the Guardians?' in The Times 4 February]

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Recent evidence given to the Megaw Inquiry on Civil Service pay simply described, at the Inquiry's request, existing mechanisms for dealing with public expenditure including public service pay. Negotiations on the pay of those public services for which central Government is directly responsible have yet to take place. Offers have yet to be made and settlements have yet to be reached. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged.

13. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made.

14. Contingency reserve and pay

Existence of Contingency Reserve does not mean that excessive public service pay settlements will be financed. If a pay increase is justified and cannot be financed within cash limits or by savings elsewhere, access to Reserve is possible. This is a decision which Ministers would have to take at the appropriate time, bearing in mind other potential calls on the reserve. Government's view remains that 4 per cent is a reasonable overall provision within its expenditure planning.

15. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

16. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is smallest for over 14 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 75,000 (over 4 per cent).

17. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

18. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

19. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

20. Will the Government limit rates as suggested by the CBI?

[Pre-Budget meeting with Chancellor 2 February]

We certainly share the CBI's concern about the harmful effect of high rates on business. The problem with limiting rates is that, unless local authorities cut their spending, it has to be paid for by domestic ratepayers or the taxpayer generally. However, we will be considering this further in the context of the longer term future of the domestic rating system. Meanwhile the Government's continuing pressure on local authorities to reduce expenditure will help all ratepayers.

21. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

22. Financial help to authorities hit by recent extreme weather?

As already announced, Government is prepared to give special financial assistance to local authorities who would otherwise suffer an undue financial burden because of effects of recent severe weather.

IF PRESSED: As in the past, assistance being offered is 75 per cent of net additional expenditure which local authorities have incurred as direct result of emergency, above a threshold of a penny rate product. [NB - NOT FOR USE - this precise wording is important.]

23. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

F SOCIAL SECURITY

1. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

2. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

3. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April/July 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

4. Death grant - increase to realistic level?

We recognise that the present death grant of £30 is of only marginal benefit, and have been looking at ways in which it could be improved. I hope there will be an announcement on this soon.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast showed PSBR in 1981-82 on target for Budget estimate of £10½ billion; PSBR in April - December published 4 February was £10¼ billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CONFIDENTIAL: CGBR April-January to be published 9 February, was £8 billion.]

Effect of dispute (concluded July 1981) was to add around £2¼-2½ billion to the CGBR in April 1981-January 1982, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement ~~earlier this year~~ he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 16 per cent in September, fell to 14½ per cent in December, and were reduced by the clearing banks to 14 per cent with effect from 25 January. Market rates were firm in early part of January, in particular reflecting increases in US market rates. In second half of January and early February, interest rates generally fell back.]

Of course we want to see lower rates. But we must proceed cautiously if we are not to let up in the fight against inflation. Despite difficult conditions abroad, interest rates have been falling.

2. Will high US rates push up our rates?

High US rates are certainly an adverse development and in September were one of the key factors in driving our rates up. Recently, however, with the pound remaining stable in world markets, our rates have been able to ease somewhat, without creating inflationary dangers. The position of the pound has no doubt been helped by better prospects for the wage round and the good trade figures. Nevertheless, the position does give cause for concern.

3. What is the Government doing about it?

As my rhF the Chancellor stated in his speech to the House of 28 January, we support the anti-inflationary stand of the US authorities. But we have made clear on many occasions our concern about the balance of fiscal and monetary policy and its implications for interest rates.

4. If US rates are determining ours, why all the concern about the PSBR?

We do not claim that US rates are sole influence on our own and that there is nothing we can do to offset our own rates. Just as we are urging a balance between fiscal and monetary policy in the US, so we must achieve that ourselves.

5. Should not European governments jointly exert pressure on US?

Other European governments have made their views known in the same way we have.

6. Interest rates levels choking the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

7. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

8. Will there be an overshoot of money supply?

[£M3 increased by 0.2 per cent in banking December. Recorded increase in first ten months of target period was 12.6 per cent, equivalent to an annual rate of 15.3 per cent. Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) December. In nine months ending December the effect of the strike was to add around £3 billion to the CGBR.

10. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

11. Plans for modifying MTFS?

Government's economic policy has evolved and developed since we have been in office - and no doubt will continue to do so - but the aims of our medium term strategy are still precisely those set out in the 1980 Budget Report - to reduce inflation and thereby create the conditions for sustained growth in output and employment. My rhF the Chancellor intends to present an updated MTFS in the forthcoming Budget.

12. What was purpose of new guidance issued to banks on mortgage lending?

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

13. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

14. Why issue another indexed gilt?

Issue of indexed stock demonstrates Government's confidence in ability to make further progress in fight against inflation.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in December.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in December at 12 per cent, compared with lowest recent level of 10.9 per cent in July. (Effect of increase in mortgage interest rates and of higher food prices estimated at about 0.2 per cent on December RPI). Industry Act forecast: 10 per cent by Q4 1982.]

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P11-12.]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less; some more. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurances they were given last year about this year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals have accepted offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. LA manuals' settlement higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[Miners have accepted offer worth 9.3 per cent on basic rates [NOT TO BE QUOTED: 7.4 per cent on earnings]; water manuals have accepted offer worth 9.1 per cent on rates, (8.8 per cent on earnings)].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. Private sector pay - CBI claim most settlements for 4-6 per cent?

[In a recent press release, the CBI asserted that the bulk of manufacturing settlements monitored since 1 August were in the 4-6 per cent range. But their own CONFIDENTIAL evidence shows a weighted average of 7.3 per cent with majority of employees over 7 per cent.]

There is no doubt that settlements have been lower in recent months, reflecting an increasing sense of realism about pay. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3 1981.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Decrease in year on year growth from 11.9 per cent in October to 11.3 per cent in November. However, (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to November straddles two pay rounds - not useful indicator of recent trends.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Incomes Policy

[Attention may be drawn to Prof. Meade's proposal in his book "Stagflation Vol I" (published 21 January) for an incomes policy, based on consensus about growth of aggregate national income, and featuring arbitration on employment - effect criteria; or to Prof. Layard's ideas for wage inflation tax (picked up by SDP).]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

[Brought up again in / Adjournment Debate 4 February]

The Government is considering the whole question in the light of the Scott Report. Our aim is to ensure that pensions to public servants are fair to taxpayers, as well as to employees, pensioners and their dependants.

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

December current account is estimated to have been £498 million in surplus, compared with £218 million in November. Most of the improvement was due to increased surplus on oil and erratic goods. Although both exports and imports fell back from the high November levels, these figures confirm the underlying recovery in UK trade.

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

Surplus on oil exports rose by £188 million to £402 million. Trade in erratics (precious stones, aircraft, ships, North Sea installations) improved by £86 million. This reflects recent trend towards surplus in ships and aircraft, consistent with UK manufacturers' general success in exporting finished capital goods.

4. Trends in imports

December import figures are in line with the average for the previous 3 months. The recovery in imports is across the board, including basic materials and manufactures used by UK industry. This supports the view that destocking is coming to an end and the economy picking up.

5. Trends in invisibles

Surplus on all invisibles is projected to be around £500 million in Q4 1981.

6. TUC proposal for an import deposit scheme?

[TUC Economic Review published 2 February]

This would raise prices in the shops, increase costs for domestic manufacturers, run counter to our international obligations and probably lead to retaliation against successful British exporters.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Sterling fell sharply during the spring and summer of 1981. Since September, it has remained broadly stable and is currently over 12 per cent lower in effective terms than a year ago. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. "Highs" were $1.97 on 30 November, DM4.365 on 28 January. Rates at noon on 5 February were $1.8673; DM4.657 and an effective rate of 91.68. Reserves at end January stood at $23.2 billion, compared with $23.3 billion at end December]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target?

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M8]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to \$14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only \$13.3 billion, compared with over \$22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

On 25 January, Foreign Ministers had a lengthy discussion on the four key issues in the negotiations over the Mandate. It was not possible to reach agreement. The main issue preventing agreement was the view of a number of other Member States that refunds to the UK should be arbitrarily and automatically reduced over time, regardless of the scale of the problem. That was quite unacceptable to the UK. There was also disagreement about the duration of the new refunds arrangement. The Presidents of the Council and Commission are now to try to find solutions to these problems.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

The most recent Commission estimates suggest that our net contributions in respect of 1980 and 1981 will be significantly lower than expected at the time of the 30 May Agreement. That is very satisfactory. For we remain one of the less prosperous Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

[FT 1 February alleged Government hardening against participating in exchange rate system.]

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

1. 3 February NEDC: outward investment damaging to the economy?

We had a valuable discussion at the February NEDC on inward and outward investment. My rhF the Chancellor stressed small impact of abolition of exchange controls on volume of real investment overseas. There had been an effect on portfolio investment, resulting in some downward pressure on the exchange rate at a time when it was being pushed upwards as a result of North Sea oil; this had been helpful to employment and activity in the export and import-competing sectors.

2. February NEDC: discussion on information technology

We had a very useful discussion on information technology. My rhF the Minister for Information Technology outlined all the ways in which the Government was providing help for this most important sector of the economy, but stressed that the information technology industries would only succeed if the private sector itself responded more vigorously to the challenges ahead. As in other sectors of the economy, UK production must be competitive in price, design, quality and servicing.

3. CBI Budget strategy suggestions?

See A 20(c).

4. Recent increases in interest rates - damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

5. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output rising in Q3 1981. Autumn Industry Forecast sees continuation of recovery in output.

6. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging. Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

SMALL FIRMS

7. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

8. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 1800 guarantees - well over half to new businesses. Total lending under scheme is already over £63 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

9. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

10. Response from private sector?

Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although we now expect the final figure

to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this financial year.

6. Future years?

Investment approvals will be published in the forthcoming Public Expenditure White Paper, as in previous years.

7. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries in aggregate should be more than able to maintain the same level of investment in 1982-83 planned in the last White Paper, despite lower revenues, with higher investment in important industrial priorities, eg telecommunications. This would represent the highest real level of investment in the industries since 1975-76.

8. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

9. Private-finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

10. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

11. Nationalised industries' prices

[Caution: gap between NI and 'all items' RPI index could widen again in near future. Factors include LT fare reductions reversal in spring, electricity discount scheme for winter only, dropping out of index of last year's double revalorisation of excise duties.]

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. But since the middle of 1980-81 the gap between industry price increases and the RPI has started to narrow sharply. Alternative policies would result in an unacceptable increased burden on taxpayer and distortion of market forces.

12. Will HMG take action over electricity price rises to large users?

The review by the Electricity Council of the CEGB's Bulk Supply Tariff has now been produced and is currently being considered by Ministers.

PRIVATISATION

13. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

14. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. The Government expect to have sold shares in the National Freight Corporation by end of this financial year. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Will HMG reduce price of North Sea oil further in face of weak market?

[BNOC have agreed $1.50 reduction with BP].

UK continental shelf prices are set by commercial negotiation. BNOC is largely a third party trader, and must find prices which satisfy both suppliers and customers.

2. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute for Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

3. Does HMG accept C&AG's criticisms of the North Sea fiscal regime?

A full review of the fiscal regime is in progress. We shall take the C&AG's observations into account.

4. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

5. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

6. <u>Government revenues from the North Sea should be used to finance cheap energy for industry</u>?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

7. <u>North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy</u>?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

8. <u>North Sea oil bond</u>?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The proposed sale of 51 per cent of BNOC's upstream business means that an oil bond is no longer necessary.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9¼ per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9¼ per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits. [For US , see 10 below]

5. Other countries giving priority to reducing unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. UK is alone in Europe. Even Germany announced investment/employment scheme last week?

No. Germany planned to reduce Government Borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

8. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasts expect UK growth this year of about 1 per cent. This is broadly in line with the OECD's forecast for our major industrial competitors. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

9. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound \$ is in everyone's best interests. Concern is that fiscal deficit should not be excessive so that too much weight has to be put on interest rates in meeting the Federal Reserve's monetary targets. All countries familiar with this problem.

10. Even US using fiscal deficit to stimulate economy?

True US deficit is larger than anticipated. It is planned to fall but present level carries risk of prolonging period of high interest rates which could delay a European recovery. We strongly support the determination of the US authorities to combat inflation. But we believe fiscal and monetary policies must work together to that goal.

11. Recent international interest rate developments?

True that US interest rates have risen again in recent weeks. Prime rates are well below their peak of 21½ per cent last summer.

12. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 8 February 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to November 1981 industrial output rose 1½ per cent while manufacturing output rose 1 per cent.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales fell back in December 1981 but the average level in Q4 1981 rose ½ per cent. The volume of visible exports in Q4 1981 was 5½ per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,829,000 (11.7 per cent) at January count, up 47,000 on December. Vacancies rose 6,700 to 114,200 in January.

Wholesale input prices (fuel and materials) rose ¾ per cent in January; however the year-on-year increase fell to 13¾ per cent. Wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase was 12.0 per cent in December. Year-on-year increase in average earnings was 11.3 per cent in November. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.7 bn and CGBR £8.5 bn (both seasonally adjusted) in the first three quarters of 1981/82; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 0.2 per cent in banking December.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-January $23.2 bn. At the close 5 February the sterling exchange rate was $1.859 and the effective rate was 91.6.

CONFIDENTIAL AND PERSONAL
Covering SECRET

1. Mr Scholar
To see.
2. CF.
Pl return the record to Mr Wiggins.
2ii

CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB, CVO

Ref. A07305

1st February 1982

Returned 8/2/82

Dear Clive,

Economic Strategy: Cabinet 28 January

I enclose a copy of the Most Confidential Record of the Cabinet's discussion on Economic Strategy on 28 January. There was no reference to the existence of this Record in the Cabinet Conclusions and it should not, therefore, be referred to or quoted.

I am sending a copy to John Kerr in the Treasury. I should be grateful if he too would ensure that the Record is not referred to and that it is only seen by officials with a real need to know its contents. It should be retained within the Treasury Private Office.

In due course, I should be grateful if copies could be returned to me in the Cabinet Office.

Yours ever,

David

C A Whitmore Esq

CONFIDENTIAL AND PERSONAL
Covering SECRET

Econ Strategy

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
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PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 25 January, are sidelined.

M M Deyes

M M DEYES

RA

R I G ALLEN

1 February 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of 1982 Budget.

4. Budget objectives

I intend to use the Budget to sustain and maintain the progress now evident. We shall continue to create the conditions for sustainable growth. We have not sought - and shall not seek - to stimulate growth directly by pulling the levers of monetary demand.

5. Scope for tax cuts?

[Reports following Cabinet 28 January suggested scope for some tax cuts in 1982-83 of order to £1-2 billion - over and above normal revalorisation - consistent with £9 billion PSBR]

Cannot foreshadow Budget. Undoubtedly, higher public spending makes prospects for PSBR, interest rates and burden of taxation next year more difficult. But, as rhF said in 2 December statement, on conventional assumptions figures point to a PSBR next year broadly in line with projections published at time of Budget. Final assessment must await Budget next year. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

6. Armstrong report - TCSC comment

[Discussion at hearing on 25 January.]

Welcome interest shown by Treasury Select Committee in Armstrong report. Very important implications for conduct of Government bodies and for Parliamentary procedure. Shall look forward to Committee's report.

7. Endorse Armstrong recommendation?

Number of practical difficulties. Issues need further examination.

8. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

9. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth in money GDP down from 17 per cent in 1980 to 10 per cent in 1981. Inflation rate halved since spring 1981 peak. Some good features in monetary picture - outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

10. Why are high interest rates needed?

Current level of interest rates has reflected both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that most bank base rates have come down by 2 per cent since September.

11. Pressure on interest rates likely following President Reagan's message ?

[State of the Union message confirmed doubling of earlier $45 billion US deficit 1982: no new proposals to offset this by tax or spending changes]

I am concerned that the US deficit in 1982 will be higher than earlier planned. I welcome the intention that it will decline in later years. Full assessment must, clearly, await release next month of precise budgetary arithmetic. As in all other countries, it is desirable that the US pursue balanced monetary and fiscal policies - this is crucial to interest rates. It is in everyone's interest that the US should defeat inflation. We know how difficult and painful the necessary decisions are.

12. Expectations for UK economy in 1982 disappointing?

[See B4 for details of December Industry Act Forecast]

No. Clouds are clearly lifting. Further falls in inflation in prospect. Good export prospects and current balance will remain in surplus. Industry Act forecast shows 1 per cent growth in 1982. Could be better than this if things go well on pay front, and if international economic recovery. Appreciable progress made on improving competitiveness and productivity. Important to build on this. Recent report from CBI West Midlands illustrates way forward -

companies have improved performance and diversified and developed products to capture new markets.

13. Productivity bound to be 'improving' when $1\frac{1}{4}$ million laid off in manufacturing in past $2\frac{1}{2}$ years?

No escaping fact that much of industry has been inefficient, overmanned. But does not follow thtat there has been permanent loss of jobs. Improved productivity/competitiveness enhances, not diminishes long-term prospect for jobs.

14. Unemployment in 1982?

Prospects for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects see C3].

15. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

16. Government has failed in objective of reducing burden of tax?

Burden has inevitably increased at time when national production not growing. But for vast majority real personal disposable income is still higher than for most of period of previous Government.

17. Inflation still higher than when Government took office?

True of the 12-month rate. But in May 1979 inflation was accelerating, on back of escalating wage settlements and higher public sector prices. 12 month rate now broadly stable and set to resume downward movement later this year.

18. Alternative courses?

(a) Moderate reflation?

Government recognise need to respond flexibility to economic situation, within framework of overall strategy. But no question of abandoning that strategy. Cannot throw away gains made so far by return to discredited policies. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing resurgence of inflation and undermining financial markets, and, as a consequence, interest rates rising further and faster. Even those who advocate reflation do not always claim very large output or employment benefits eg NIESR £5 billion package would reduce unemployment by only 150-300,000 after 5 years.

(b) £8.3 billion package apparently proposed by TUC?

[Press reports in advance of release of Annual Economic Review on 2 February report call for five-year strategy and immediate increases in public sector capital spending (£2.1 billion) social spending (£1.5 billion) and employment and training measures (£1.2 billion): suggest VAT cut equivalent to £2 billion]

TUC's programme unclear how programme should be financed without extra borrowing and all that means for interest rates and consequent impact on the economy.

(c) Mr Shore's proposals in Economic Debate 28 January?

[Briefing to follow]

(d) Mrs Williams ' plans to reduce unemployment by 1 million in 2-3 years
[Newsnight programme 28 January]

Hard to believe in this optimistic scenario -to be achieved apparently without inflationary effects - too good to be true.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Latest information on output, production and stocks - recession over?

Fall in output now over. GDP output on latest - revised - figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2. Manufacturing and construction output increased by some 2 per cent in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking one-third that of H1 1981. Latest FT Business Opinion Survey (January) shows further improvement in business optimism and export prospects.

[NB CBI Situation Report for January to be released Tuesday 2 February; separate briefing will be supplied.]

2. Latest industrial production figures show rise in output faltering?

[Industrial and manufacturing output in November both down 1½ per cent in November, though up 1½ and 1 per cent respectively in 3 months to November compared previous three.]

Bound to be monthly fluctuations: fall in November due in part to BL and Ford disputes. Allowing for these, November index remained somewhat above its September level.

3. Other evidence of improvement in economy?

Latest (November) figures show net new construction orders in 1981 up 9 per cent on H2 1980. Net new engineering orders 17 per cent; within this, export orders up 21 per cent in same period. Latest (December) figures for retail sales up 2 per cent between 1980 and 1981. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980.

December cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November and December.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

4. Government assessment of prospects

[New Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat.]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

5. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR	LBS	CBI	Phillips & Drew	OECD	IAF
	(Nov)	(Nov)	(Nov)	(Feb)	(Jan)	(Dec)
Per cent change 1982 on 1981	+½	+1¾	+1	+1	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic, seeing recovery delayed into 1983. ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

6. High interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

C LABOUR

1. Unemployment continues to rise?

[January total count was 3,071,000 (12.7 per cent). Seasonally adjusted excluding school leavers figure was 2,829,000 (11.7 per cent).]

Magnitude of January rise reflects, in addition to normal seasonal increase, abnormally severe weather. Underlying rate continues to rise much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut - (down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised. Vacancies continue to improve: both in total available and rate of new ones being notified.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment fell back 32,000 a month in three months to November, compared with 50,000 a month earlier in 1981.).]

Third quarter decline in total employment half that in H1 1981. Manufacturing employment statistics show lower rate of decrease was maintained into fourth quarter.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED on whether unemployment will "peak" in 1982: Mr Burns referred in evidence to TCSC (December 1981) to unemployment assumption given to Government Actuary; said it was not far from Treasury assessments. GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). Reflected in wider range especially for beyond 1982.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Yes, but it has reached record levels in a number of other industrial countries. In France, despite President Mitterand's expansionist policies, it has gone over 2 million. In Germany it has reached 1.7 million, the highest figure since the early post-war period. In Germany and Holland, unemployment has increased 50 per cent in the past year, and in the last few months, most OECD countries have seen steeper rises than Britain. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment; (figure of £450 million estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. Treasury's internal revision of figure published in February 1981 Economic Progress Report not published so far - further articles likely to be published in EPR and Employment Gazette in near future.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed. As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

7. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a lot to help. Special employment and training measures currently cover almost 700,000 people at cost of over £1,100 million this financial year. Not easy to assess just how many being kept off register by SEMs, but Department of Employment estimate at around 345,000.

8. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 increased to over £520 million, with additional £61 million for young worker scheme starting on 6 January 1982. New Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be some £1½ billion - almost £800 million more than in last Public Spending White Paper (revalued).

9. Need to bring system of industrial training up to date?

Agreed. White Paper 'New Training Initiative' sets out action required in industry and education as well as lead from Government. New Youth Training Scheme will guarantee full year's foundation training to those leaving school at minimum age. Government objective that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. 'Open Tech' programme being developed to make technical training available to those with ability to benefit.

10. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

11. What has Government done to make labour market more flexible?

Have taken action on a number of points:

Training: extra spending on 16-17 year olds plans to reform apprenticeship system (see C9 above).

Young workers: subsidy to employers to take on youngsters at lower wage rates - object to price young back into labour market.

Mobility: Housing Act 1980 provisions for short-term tenancy in private rented sector.

Industrial relations: steps already taken and further proposals just published to redress imbalance of power between employers and unions.

Employment Act 1980 measures to reduce costs of employment and rigidity in wage-setting practices.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. Not worse than in other countries?

Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

3. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in 2 December statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. (See G5.) Other factors will also be important, including monetary targets and outlook for pay and inflation.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be greatest help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

6. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

7. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

8. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982). The Green Paper shows that burden of corporation tax has more or less matched changes in company profitability. The question of appropriate burden of corporation tax is not covered in Green Paper, but will be considered by my rhF in reaching his Budget decisions.

9. The burden of corporation tax is too high/not high enough?

The Green Paper is not concerned with the burden of corporation tax but with its structure. It does show, however that burden of corporation tax has more or less matched changes in company profitability. The related question of appropriate burden of corporation tax is not covered in Green Paper but will be considered by my rhF in reaching his Budget decisions.

10. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

11. North Sea fiscal regime?

See R2-3.

12. Black economy a cost to the country ?

/Article by Mr Johnson in Lloyds Bank's Economic Bulletin /

It is by nature impossible to measure the size of the "black economy". Mr Johnson's figures for the share of GDP are not inconsistent with those used by the Inland Revenue, although his estimate of the number of people fully engaged in it seem unrealistically high.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

[Outturn for current year expected to be in region of £107 billion against £105 billion (revalued and adjusted) in last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring; changes in circumstances could well lead to higher or lower total than £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

5. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

8. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with the cash equivalent of the last White Paper, but keen tendering will mean the programmes should be carried out as planned.

9. Number of cash limits breached last year?

[Full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as White Paper (Cmnd 8437) on 4 December.]

In aggregate, central government voted cash limits in 1980-81 were underspent by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Government overspending by £1,250 million?

[D Blake in The Times 27 January.]

My rhF's statement 2 December gave global adjustment of £3,300 million in arriving at total of £115 billion. Statement explained clearly that the £3,300 million included not only the contingency reserve [NOT FOR USE: not then decided] but also allowance for the effect on programmes [notably social security, housing and export credit guarantees] of revised economic assumptions.

12. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

13. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is smallest for over 14 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 75,000 (over 4 per cent).

14. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

15. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

16. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

17. Increased burden on industry?

Very conscious of harmful effect of large rate increases. But remedy lies with local authorities. Realism of Government's plans means that there is no need for high rate increases.

18. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

19. Financial help to authorities hit by recent extreme weather?

As already announced, Government is prepared to give special financial assistance to local authorities who would otherwise suffer an undue financial burden because of effects of recent severe weather.

IF PRESSED: As in the past, assistance being offered is 75 per cent of net additional expenditure which local authorities have incurred as direct result of emergency, above a threshold of a penny rate product. [NB - NOT FOR USE - this precise wording is important.]

20. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

21. No protection for industry?

An alternative to non-domestic rates involves much wider, more difficult questions. But interests of non-domestic ratepayers will be a most important consideration in developing a policy on domestic rates. Government's continuing pressure on local authorities to reduce expenditure (through Bill, block grant, cut in RSG percentage) will help all ratepayers.

F SOCIAL SECURITY

1. Increase in employees' national insurance contributions?

[Chancellor and Social Services Secretary announced on 2 December 1 per cent increase in employees' national insurance contribution (from 7.75 to 8.75 per cent) from April 1982, as part of review of National Insurance Contributions. Increase will help to increase TPI from April - see J3. Social Security (Contributions) Bill to implement is through Commons: Lords Committee Stage 28 December.]

An increase in contributions was necessary to pay for increased benefit expenditure (notably retirement pensions), increased redundancy payments and to maintain expenditure on the health service. Relative share of these costs met by employers has increased in recent years; we consided it essential to avoid placing this additional burden on them. Employers will still be bearing a higher proportion of the burden than they did ten years ago.

2. What about Treasury Supplement?

[Bill provides for 1½ per cent reduction in Treasury Supplement - from 14.5 to 13 per cent].

Treasury Supplement represents only one part of cost of benefit expenditure met by the general taxpayer. If all such expenditure taken into account, general taxpayer will still be funding as high a proportion of benefit expenditure in 1982-83 as this year - and substantially more than a few years ago. Not, therefore, unreasonable for contributors, rather than general taxpayer, to meet these extra costs.

3. Burden on employers?

We have avoided making any increase in employers' rate of contributions. Some increase in cash burden is, however, inevitable simply because of higher earnings. In addition, upper earnings limit has been raised by £20 to £220 - which adds a relatively small additional cash burden. Cash payments expected to increase by around 7 per cent, that is, slightly less than our estimate of the movement between 1981-82 and 1982-83 in earnings (7.5 per cent) and substantially less than the movement in prices (10 per cent).

4. Balance on the Fund?

We are budgeting for a very small deficit (£9 million) this year. The accumulated balance in the National Insurance Fund is of order of £5 billion. This may seem large as a proportion of expenditure; it has, however, been falling, and now represents about 13 weeks benefit expenditure - as compared with 25 to 30 weeks ten years ago. A balance of some weeks expenditure is necessary to cope with emergencies such as flu epidemics and industrial disputes.

5. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

6. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

7. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast published 2 December shows PSBR in 1981-82 was £10.2 billion; PSBR in April - September was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CGBR April-December was £10¾ billion.]

Effect of dispute (concluded July) was to add around £3 billion to the CGBR, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 15 per cent in September, fell to 14½ per cent in December, and were reduced by three of the clearing banks to 14 per cent on 22 January. Market rates were firm in early part of January, in particular reflecting increases in US market rates. In second half of January, interest rates generally fell back.]

Of course we want to see lower rates. But we must proceed cautiously if we are not to let up in the fight against inflation. Clearing banks have now reduced base rates by 2 per cent from their peak.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

5. Will there be an overshoot of money supply?

[£M3 increased by 0.2 per cent in banking December. Recorded increase in first ten months of target period was 12.6 per cent, equivalent to an annual rate of 15.3 per cent. Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high.

6. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) December. In nine months ending December the effect of the strike was to add around £3 billion to the CGBR.

7. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

8. Plans for modifying MTFS?

We shall consider the MTFS published with last year's Budget - but have no plans to revise the broad objectives. Too early to comment precisely on what form this will take, or how next year's financial targets will be presented.

9. What was purpose of new guidance issued to banks on mortgage lending?

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

10. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

11. Why issue another indexed gilt?

Issue of indexed stock demonstrates Government's confidence in ability to make further progress in fight against inflation.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in December.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in December at 12 per cent, compared with lowest recent level of 10.9 per cent in July. Effect of increase in mortgage interest rates and of higher food prices estimated at about 0.2 per cent on December RPI. Industry Act forecast: 12 per cent by Q4 1981; 10 per cent Q4 1982.

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be $1\frac{1}{2}$-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P14-15.]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly $3\frac{1}{2}$ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less; some more. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurance they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals have accepted offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. LA manuals' settlement higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[Miners have accepted offer worth 9.3 per cent on basic rates [NOT TO BE QUOTED: 7.4 per cent on earnings]; water manuals have accepted offer worth 9.1 per cent on rates, (8.8 per cent on earnings)].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. Private sector pay

[BL settled at 4½-5 per cent, National Engineering Agreement added only 5.1 per cent to basic rates; however Vauxhall manuals have settled at 7.9 per cent, Ford unions at 7.4 per cent. NOT TO BE QUOTED: Cumulative average for private sector in round so far estimated at 6½ per cent by DE]

There have been some welcome signs of lower wage settlements in the private sector so far in the pay round. CBI report that bulk of settlements in manufacturing this round here been in the 4-6 per cent range. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Decrease in year on year growth from 11.9 per cent in October to 11.3 per cent in November. However, (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to November straddles two pay rounds - not useful indicator of recent trends.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Incomes Policy

[Attention may be drawn to Prof. Meade's proposal in his book "Stagflation Vol I" (published 21 January) for an incomes policy, based on consensus about growth of aggregate national income, and featuring arbitration on employment - effect criteria; or to Prof. Layard's ideas for wage inflation tax (picked up by SDP).]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

We are considering question of index-linking of public service and other public sector pensions, including the question of contributions made by public servants for their pensions. Changes in these arrangements could produce further savings in due course.

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

December current account is estimated to have been £498 million in surplus, compared with £218 million in November. Most of the improvement was due to increased surplus on oil and erratic goods. Although both exports and imports fell back from the high November levels, these figures confirm the underlying recovery in UK trade.

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

Surplus on oil exports rose by £188 million to £402 million. Trade in erratics (precious stones, aircraft, ships, North Sea installations) improved by £86 million. This reflects recent trend towards surplus in ships and aircraft, consistent with UK manufacturers' general success in exporting finished capital goods.

4. Trends in imports

December import figures are in line with the average for the previous 3 months. The recovery in imports is across the board, including basic materials and manufactures used by UK industry. This supports the view that destocking is coming to an end and the economy picking up.

5. Trends in invisibles

Surplus on all invisibles is projected to be around £500 million in Q4 1981.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Sterling fell sharply during the spring and summer of 1981. Since September, it has remained broadly stable and is currently over 12 per cent lower in effective terms than a year ago. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. "Highs" were [1.97 on 30 November, DM4.365 on 28 January. Rates at noon on 29 January were $1.8835; DM4.348 and an effective rate of 91.59. Reserves at end December* stood at $23.3 billion, compared with $23.4 billion at end November]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

[NB January reserves figures due to be published 2.30 pm 2 February]

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M8]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

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* Latest available at time of writing.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only $13.3 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

On 25 January, Foreign Ministers had a lengthy discussion on the four key issues in the negotiations over the Mandate. It was not possible to reach agreement. The main issue preventing agreement was the view of a number of other Member States that refunds to the UK should be arbitrarily and automatically reduced over time, regardless of the scale of the problem. That was quite unacceptable to the UK. There was also disagreement about the duration of the new refunds arrangement. The Presidents of the Council and Commission are now to try to find solutions to these problems.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

The most recent Commission estimates suggest that our net contributions in respect of 1980 and 1981 will be significantly lower than expected at the time of the 30 May Agreement. That is very satisfactory. For we remain one of the less prosperous Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. <u>Costs of CAP to UK consumers</u>

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. <u>What is the current attitude of the UK Government?</u>

[FT 1 February alleges Government hardening against participating in exchange rate system.]

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

/NB Chancellor will be seeing CBI on Tuesday 2 February /

1. Recent increases in interest rates - damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output rising in Q3 1981. Autumn Industry Forecast sees continuation of recovery in output.

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging. Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

4. Industry claims that 2 December package adds £600 million to employers' costs?

[Higher NIC £200 million; higher rates £400 million.]

In real terms burden of NIC/NIS on employer's likely to fall in 1982-83, for second year in succession. And company sector now in rather stronger financial position than a year ago, partly through Government policies to switch fiscal burden.

SMALL FIRMS

5. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

6. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued more than 1800 guarantees - well over half to new businesses. Total lending under scheme is already over £63 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

8. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although we now expect the final figure

to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this financial year.

6. Future years?

Investment approvals will be published in the forthcoming Public Expenditure White Paper, as in previous years.

7. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries in aggregate should be more than able to maintain the same level of investment in 1982-83 planned in the last White Paper, despite lower revenues, with higher investment in important industrial priorities, eg telecommunications. This would represent the highest real level of investment in the industries since 1975-76.

8. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

9. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

10. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

11. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. But since the middle of 1980-81 the gap between industry price increases and the RPI has started to narrow sharply. Alternative policies would result in an unacceptable increased burden on taxpayer and distortion of market forces.

12. Will HMG take action over electricity price rises to large users?

The review by the Electricity Council of the CEGB's Bulk Supply Tariff has now been produced and is currently being considered by Ministers.

PRIVATISATION

13. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

14. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. The Government expect to have sold shares in the National Freight Corporation by end of this financial year. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute for Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

3. Does HMG accept C&AG's criticisms of the North Sea fiscal regime?

A full review of the fiscal regime is in progress. We shall take the C&AG's observations into account.

4. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

5. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

6. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

7. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The proposed sale of 51 per cent of BNOC's upstream business means that an oil bond is no longer necessary.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9¼ per cent in December. Underlying rates falling in US and rising in Italy. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9¼ per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

5. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the

deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasts expect UK growth this year of about 1 per cent. This is broadly in line with the OECD's forecast for our major industrial competitors. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is that fiscal deficit should not be excessive so that too much weight has to be put on interest rates in meeting the Federal Reserve's monetary targets. All countries familiar with this problem.

9. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

10. Recent international interest rate developments?

True that US interest rates have tended to rise again in recent weeks. Prime rates are well below their peak of 21½ per cent last summer, but only firm control of US budget deficit will bring lasting reduction in interest rates.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 1 February 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to November 1981 industrial output rose 1½ per cent while manufacturing output rose 1 per cent.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales fell back in December 1981 but the average level in Q4 1981 rose ½ per cent. The volume of visible exports in Q4 1981 was 5½ per cent higher than a year earlier. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,781,600 (11.5 per cent) at December count, up 17,300 on November. Vacancies rose slightly to 107,500 in December.

Wholesale input prices (fuel and materials) were unchanged in December; the year-on-year increase fell to 15½ per cent. Wholesale output prices rose ½ per cent and are 11¾ per cent above a year ago. Year-on-year RPI increase was 12.0 per cent in December. Year-on-year increase in average earnings was 11.3 per cent in November. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to December - £10.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 0.2 per cent in banking December.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-December $23.3 bn. At the close on 29 January the sterling exchange rate was $1.8810 and the effective rate was 91.7.

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.

House of Commons Hansard,
28 January 1982, columns 1010 - 1098
"Economic Policy of the Government"

Signed C Wayland Date 16 August 2012

PREM Records Team

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PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 18 January, are sidelined.

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RA

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25 January 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. Has Government downgraded £M3 and PSBR?

That is an extraordinary conclusion to draw from rhF Chancellor's statement on 2 December and his recent evidence to TCSC Committee (also December). Consistent emphasis on need to keep steady but not excessive downward pressure on monetary variables and to restrain government borrowing.

4. Restatement of Government strategy?

Budget is customarily the occasion for a full statement of economic policy. I am sure my rhF Chancellor intends no departure from this tradition.

5. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of 1982 Budget.

6. Date of 1982 Budget?

Tuesday 9 March.

7. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

8. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth in money GDP down from 17 per cent in 1980 to 10 per cent in 1981. Inflation rate halved since spring 1981 peak. Some good features in monetary picture - outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

9. Why are high interest rates needed?

[UK has abandoned domestic control rates now fixed in Wall Street - claim by D Blake in The Times 14 January]

Current level of interest rates has reflected both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that most bank base rates have come down by 2 per cent since September.

10. Expectations for 1982 disappointing?

[See B4 for details of December Industry Act Forecast]

No. Clouds are clearly lifting. Further falls in inflation in prospect. Recovery in output expected to continue. Good export prospects and current balance will remain in surplus. Admittedly a gradual undramatic recovery, but UK operating in difficult economic environment. Appreciable progress made on improving competitiveness and productivity. Important to build on this.

11. Unemployment in 1982?

Prospects for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects see C3].

12. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

13. Scope for tax cuts?

[Riddell article, FT 25 January, suggests that, with £9 billion PSBR, 1982-83, room for tax cuts of at least £1 billion (over and above 'conventional indexation')]

Cannot foreshadow Budget. Undoubtedly, higher public spending makes prospects for PSBR, interest rates and burden of taxation next year more difficult. But, as rhF said in 2 December statement, on conventional assumptions figures point to a PSBR next year broadly in line with projections published at time of Budget. Final assessment must await Budget next year. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

14. Government should change course?

(a) Moderate reflation the answer?

Government recognise need to respond flexibility to economic situation, within framework of overall strategy. But no question of abandoning that strategy. Cannot throw away gains made so far by return to discredited policies. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing resurgence of inflation and undermining financial markets, and, as a consequence, interest rates rising further and faster. Even large reflationary packages yield relatively small benefits eg NIESR £5 billion package would reduce unemployment by only 150-300,000 after 5 years.

(b) £9 billion package proposed by Mr David Steel?

[Liberals' paper 'A Chance to Work' released 7 January]

To a large extent a blown-up recapitulation of their earlier programme. Costing and job benefits optimistic (£9 billion expenditure; £3 billion PSBR; 1½ million jobs in three years) - inflation implications hidden behind reliance on incomes, policy. Results rosy compared other reflationary packages (e.g NIESR see 14 (a) above).

(c) Reintroduce exchange controls and join EMS?

EMS is not a panacea. But Government does fully support EMS as an important step in monetary co-operation and closer integration in the European Community. Have stated that UK will participate in the EMS exchange rate mechanism when conditions appropriate both for the system and ourselves. Question is kept under constant review.

(d) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Latest information on output, production and stocks - recession over?

Fall in output now over. GDP output on latest - revised - figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2. Manufacturing and construction output increased by some 2 per cent in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking one-third that of H1 1981.

2. Latest industrial production figures show rise in output faltering?

[Industrial and manufacturing output in November both down 1½ per cent in November, though up 1½ and 1 per cent respectively in 3 months to November compared previous three.]

Bound to be monthly fluctuations: fall in November due in part to BL and Ford disputes. Allowing for these, November index remained somewhat above its September level.

3. Other evidence of improvement in economy?

Latest (November) figures show net new construction orders in 1981 up 9 per cent on H2 1980. Net new engineering orders 17 per cent; within this, export orders up 21 per cent in same period. Latest (December) figures for retail sales up 2 per cent between 1980 and 1981. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980.

December cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November and December.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

4. Government assessment of prospects

[New Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat.]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

5. Investment prospects gloomy?

[Q3 1981 figures show little change for manufacturers and distributors' capital investment since Q1. December DOI investment intentions survey indicates 2 per cent rise for combined total manufacturers distributors and services (MDS) in 1982, bigger increase in 1983, but 1 per cent fall for manufacturers in 1982 (upturn in H2 1982).]

Welcome signs that decline in MDS investment is over, and DOI intentions survey points to prospect of rising investment over next two years.

[IF PRESSED on further decline in manufacturers' investment:

Survey points to pick-up in manufacturing during 1982.

IF PRESSED on consistency with Treasury forecasts. Early days yet; but latest information not inconsistent with IAF.]

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR	LBS	CBI	Phillips & Drew	OECD	IAF
	(Nov)	(Nov)	(Nov)	(Jan)	(Jan)	(Dec)
Per cent change 1982 on 1981	+½	+1¾	+1	+1	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic, seeing recovery delayed into 1983. ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

7. High interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

C LABOUR

1. Unemployment continues to rise?

[NB January unemployment figures due out 26 January. Separate briefing will be supplied.]

[December* total count was 2,941,000 (12.2 per cent) - third consecutive month showing slight decrease. Seasonally adjusted excluding school leavers figure was 2,782,000 (11.5 per cent).]

Unemployment rising much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month in H2 1981 compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut -(down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised. Vacancies improving too.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 indications are that total employment declined at half the rate in H1 1981 (150,000 compared with 300,000 per quarter).]

Decline in manufacturing employment showing signs of further marked slackening in 3 months to October 1981 (28,000 compared with about 50,000 per month earlier in year), and 80,000 per month in H2 1980.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED on whether unemployment will "peak" in 1982. Mr Burns referred in evidence to TCSC (December 1981) to unemployment assumption given to Government Actuary; said it was not far from Treasury assessments. GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

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*Latest available at time of writing.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in wider range especially for beyond next year.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment; (figure of £450 million estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. Treasury's internal revision of figure published in February 1981 Economic Progress Report not published so far - further articles likely to be published in EPR and Employment Gazette in near future.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed. As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

7. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

8. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 increased to over £520 million, with additional £61 million for young worker scheme starting on 6 January 1982. New Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be some £1½ billion - almost £800 million more than in last Public Spending White Paper (revalued).

9. Need to bring system of industrial training up to date?

Agreed. White Paper 'New Training Initiative' sets out action required in industry and education as well as lead from Government. New Youth Training Scheme will guarantee full year's foundation training to those leaving school at minimum age. Government objective that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. 'Open Tech' programme being developed to make technical training available to those with ability to benefit.

10. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. Not worse than in other countries?

Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

3. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in 2 December statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. Other factors will also be important, including monetary targets and outlook for pay and inflation.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be greatest help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

6. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

7. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

8. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982)

9. The burden of corporation tax is too high/not high enough?

The Green Paper is not concerned with the burden of corporation tax but with its structure. It does show, however that burden of corporation tax has more or less matched changes in company profitability. The related question of appropriate burden of corporation tax is not covered in Green Paper but will be considered by my rhF in reaching his Budget decisions.

10. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

11. North Sea fiscal regime?

See R2.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

[Outturn for current year expected to be in region of £107 billion against £105 billion (revalued and adjusted) in last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring; changes in circumstances could well lead to higher or lower total than £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

5. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

8. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with this, but keen tendering will mean the programmes should be carried out as planned.

9. Number of cash limits breached last year?

[Full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as White Paper (Cmnd 8437) on 4 December.]

In aggregate, central government voted cash limits in 1980-81 were underspent by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the throughout public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

12. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is smallest for over 14 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 90,000 (over 4 per cent).

13. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

14. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

15. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

16. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

17. Increased burden on industry?

Very conscious of harmful effect of large rate increases. But remedy lies with local authorities. Realism of Government's plans means that there is no need for high rate increases.

18. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

19. Financial help to authorities hit by recent extreme weather?

As already announced, Government is prepared to give special financial assistance to local authorities who would otherwise suffer an undue financial burden because of effects of recent severe weather.

IF PRESSED: As in the past, assistance being offered is 75 per cent of net additional expenditure which local authorities have incurred as direct result of emergency, above a threshold of a penny rate product. [NB - NOT FOR USE - this precise wording is important.]

20. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

21. No protection for industry?

An alternative to non-domestic rates involves much wider, more difficult questions. But interests of non-domestic ratepayers will be a most important consideration in developing a policy on domestic rates. Government's continuing pressure on local authorities to reduce expenditure (through Bill, block grant, cut in RSG percentage) will help all ratepayers.

F SOCIAL SECURITY

1. Increase in employees' national insurance contributions?

[Chancellor and Social Services Secretary announced on 2 December 1 per cent increase in employees' national insurance contribution (from 7.75 to 8.75 per cent) from April 1982, as part of review of National Insurance Contributions. Increase will help to increase TPI from April - see J3. Social Security (Contributions) Bill to implement is through Commons: Lords Committee Stage 28 December.]

An increase in contributions was necessary to pay for increased benefit expenditure (notably retirement pensions), increased redundancy payments and to maintain expenditure on the health service. Relative share of these costs met by employers has increased in recent years; we consided it essential to avoid placing this additional burden on them. Employers will still be bearing a higher proportion of the burden than they did ten years ago.

2. What about Treasury Supplement?

[Bill provides for $1\frac{1}{2}$ per cent reduction in Treasury Supplement - from 14.5 to 13 per cent].

Treasury Supplement represents only one part of cost of benefit expenditure met by the general taxpayer. If all such expenditure taken into account, general taxpayer will still be funding as high a proportion of benefit expenditure in 1982-83 as this year - and substantially more than a few years ago. Not, therefore, unreasonable for contributors, rather than general taxpayer, to meet these extra costs.

3. Burden on employers?

We have avoided making any increase in employers' rate of contributions. Some increase in cash burden is, however, inevitable simply because of higher earnings. In addition, upper earnings limit has been raised by £20 to £220 - which adds a relatively small additional cash burden. Cash payments expected to increase by around 7 per cent, that is, slightly less than our estimate of the movement between 1981-82 and 1982-83 in earnings (7.5 per cent) and substantially less than the movement in prices (10 per cent).

4. Balance on the Fund?

We are budgeting for a very small deficit (£9 million) this year. The accumulated balance in the National Insurance Fund is of order of £5 billion. This may seem large as a proportion of expenditure; it has, however, been falling, and now represents about 13 weeks benefit expenditure - as compared with 25 to 30 weeks ten years ago. A balance of some weeks expenditure is necessary to cope with emergencies such as flu epidemics and industrial disputes.

5. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

6. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

7. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast published 2 December shows PSBR in 1981-82 was £10.2 billion; PSBR in April - September was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CGBR April-December was £10¼ billion.]

Effect of dispute (concluded July) was to add around £3 billion to the CGBR, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

[P Riddell in FT 25 January reports HMT keen keep to £9bn PSBR 1982-83 implied in MTFS]

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 15 per cent in September, fell to 14½ per cent in December, and were reduced by three of the clearing banks to 14 per cent on 22 January. Market rates firmed a little in December and remained firm so far in early part of January, in particular reflecting increases in US market rates. In the third week of January, interest rates generally fell back.]

Of course we want to see lower rates. But we must proceed cautiously if we are not to let up in the fight against inflation. Most clearing banks have now reduced base rates by 2 per cent from their peak.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

5. Will there be an overshoot of money supply?

[£M3 increased by 0.2 per cent in banking December. Recorded increase in first ten months of target period was 12.6 per cent. (These statistics relate to new monetary sector introduced at mid-November - following introduction of new monetary control arragements in August -which is wider than old banking sector as it includes all recognised banks, licensed deposit takers, and trustee savings banks. Effect of change was a once-for-all increase in level of £M3 which is excluded from growth figures given above.) Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high,

6. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) December. In nine months ending December the effect of the strike was to add around £3 billion to the CGBR.

7. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

8. Plans for modifying MTFS?

We shall consider the MTFS published with last year's Budget - but have no plans to revise the broad objectives. Too early to comment precisely on what form this will take, or how next year's financial targets will be presented.

9. What was purpose of new guidance issued to banks on mortgage lending?

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

10. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in December.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in December at 12 per cent, compared with lowest recent level of 10.9 per cent in July. Effect of increase in mortgage interest rates and of higher food prices estimated at about 0.2 per cent on December RPI. Industry Act forecast: 12 per cent by Q4 1981; 10 per cent Q4 1982.

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P14-15.]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less; some more. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurance they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals considering offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. Offer to LA manuals higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[Miners have voted not to reject offer worth 9.3 per cent on basic rates [NOT TO BE QUOTED: 7.4 per cent on earnings]; water manuals have accepted offer worth 9.1 per cent on rates, (8.8 per cent on earnings)].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. Private sector pay

[BL settled at 4½-5 per cent, National Engineering Agreement added only 5.1 per cent to basic rates; however Vauxhall manuals have settled at 7.9 per cent, Ford unions accepted 7.4 per cent. NOT TO BE QUOTED: Cumulative average for private sector in round so far estimated at 6½ per cent by DE]

There have been some welcome signs of lower wage settlements in the private sector so far in the pay round. CBI report that bulk of settlements in manufacturing this round have been in the 4-6 per cent range. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Decrease in year on year growth from 11.9 per cent in October to 11.3 per cent in November. However, (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to November straddles two pay rounds - not useful indicator of recent trends.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Incomes Policy

[Attention may be drawn to Prof. Meade's proposal in his book "Stagflation Vol I" (published 21 January) for an incomes policy, based on consensus about growth of aggregate national income, and featuring arbitration on employment - effect criteria; or to Prof. Layard's ideas for wage inflation tax (picked up by SDP).]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

We are considering question of index-linking of public service and other public sector pensions, including the question of contributions made by public servants for their pensions. Changes in these arrangements could produce further savings in due course.

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

December current account is estimated to have been £498 million in surplus, compared with £218 million in November. Most of the improvement was due to increased surplus on oil and erratic goods. Although both exports and imports fell back from the high November levels, these figures confirm the underlying recovery in UK trade.

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

Surplus on oil exports rose by £188 million to £402 million. Trade in erratics (precious stones, aircraft, ships, North Sea installations) improved by £86 million. This reflects recent trend towards surplus in ships and aircraft, consistent with UK manufacturers' general success in exporting finished capital goods.

4. Trends in imports

December import figures are in line with the average for the previous 3 months. The recovery in imports is across the board, including basic materials and manufactures used by UK industry. This supports the view that destocking is coming to an and and the economy picking up.

5. Trends in invisibles

Surplus on all invisibles is projected to be around £500 million in Q4 1981.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since last summer sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark, due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 22 January were $1.8700; DM4.30 and an effective rate of 90.64. Reserves at end December stood at $23.3 billion, compared with $23.4 billion at end November]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M8]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only $13.3 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

Community Foreign Ministers met informally in Brussels on 14-15 January. The meeting did not solve all the outstanding problems, particularly in relation to the milk regime and the budget. But some progress was made. Foreign Ministers will consider matters further at their meeting on 25 January. *

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We are examining the new Commission estimates. If our adjusted net contribution in respect of 1980 and 1981 turns out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

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* Latest information at time of writing

EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

1. Recent increases in interest rates - damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output rising in Q3 1981. Autumn Industry Forecast sees continuation of recovery in output.

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

4. Industry claims that 2 December package adds £600 million to employers' costs?

[Higher NIC £200 million; higher rates £400 million.]

In real terms burden of NIC/NIS on employers likely to fall in 1982-83, for second year in succession. And company sector now in rather stronger financial position than a year ago, partly through Government policies to switch fiscal burden.

SMALL FIRMS

5. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business

Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

6. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued more than 1800 guarantees - well over half to new businesses. Total lending under scheme is already over £63 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

8. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Why not give British Telecom more?

The £340 million EFL is still relatively large, particularly for a profitable industry. Ministers will be looking to British Telecom, as to others, to make a substantial contribution through reduced costs. There could be a higher figure if the bond proves feasible.

5. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

6. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this year.

7. Future years?

Investment approvals for the years 1982-83, 1983-84 and 1984-85 have yet to be settled. They will be communicated to the industries in due course and will be published in the forthcoming Public Expenditure White Paper.

8. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries should be able, in total, to maintain broadly the same level of investment in 1982-83 as planned in the last White Paper, despite lower revenue, with higher investment in important industrial priorities, eg telecommunications. This will enable the 15 per cent real increase over the 1980-81 level, which was included in the 1981-82 plans to be sustained. These plans, in turn, represented the highest real level of investment in the industries since 1975-76.

9. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

10. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

11. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

12. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £350 million this year.

13. Nationalised industries not reducing high cost of overmanning?

6.6 per cent of working population are employed in nationalised industries. Nationalised industry manpower reductions since we came into office will reach 200,000 in 1982.

NATIONALISED INDUSTRY PAY AND PRICES

14. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. Alternative would have been an increased burden on taxpayer and distortion of market forces. But rate of nationalised industry price increases is now coming more closely into line with RPI.

15. Will HMG take action over electricity price rises to large users?

The review by the Electricity COuncil of the CEGB's Bulk Supply Tariff Review has now been produced and is currently being considered by Ministers.

PRIVATISATION

16. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute for Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

3. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

4. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

5. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

6. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The sale of 51 per cent of BNOC's upstream business means that an oil bond is no longer necessary.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9½ per cent in November. Underlying rates falling in US and rising in Italy. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9½ per cent in November 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

5. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the

deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasts expect UK growth this year of about 1 per cent. This is broadly in line with the OECD's forecast for our major industrial competitors. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is that fiscal deficit should not be excessive so that too much weight has to be put on interest rates in meeting the Federal Reserve's monetary targets. All countries familiar with this problem.

9. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

10. Recent international interest rate developments?

True that US interest rates have tended to rise again in recent weeks. Prime rates are well below their peak of 21½ per cent last summer, but only firm control of US budget deficit will bring lasting reduction in interest rates.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY

25 January 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to November 1981 industrial output rose 1½ per cent while manufacturing output rose 1 per cent.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales fell back in December 1981 but the average level in Q4 1981 rose ½ per cent. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,781,600 (11.5 per cent) at December count, up 17,300 on November. Vacancies rose slightly to 107,500 in December.

Wholesale input prices (fuel and materials) were unchanged in December; the year-on-year increase fell to 15½ per cent. Wholesale output prices rose ½ per cent and are 11¼ per cent above a year ago. Year-on-year RPI increase was 12.0 per cent in December. Year-on-year increase in average earnings was 11.3 per cent in November. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to December - £10.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 0.2 per cent in banking December.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-December $23.3 bn. At the close on 22 January the sterling exchange rate was $1.873 and the effective rate was 90.9.

CONFIDENTIAL

Econ Pol.

Prime Minister (2)

MES 25/1

PRIME MINISTER

PAY BRIEF

I attach my Department's pay brief for January. I am sending copies to members of E, E(PSP), and E(EA) Committees, and to Sir Robert Armstrong.

NT

N T

25 January 1982

25 JAN 1982

PAY BRIEF: POSITION AT MID-JANUARY

SETTLEMENTS

1 Since the December pay brief 100 settlements covering 741,000 employees have been recorded. Only 2 settlements covering 35,000 employees are in the public sector; the weighted average of 8½% is dominated by the 8.8% increase for Water Supply manuals (30,600). In the private sector (98 settlements covering 706,000 employees) the weighted average level of these settlements is just over 5½%, due mainly to a 4½% settlement for Motor Vehicle Retail and Repair (370,000).

2 The cumulative weighted average level for the whole economy this pay round - 289 settlements covering 1,727,000 employees is just under 7½% compared with 8½% last month. Just under 15% of employees about whom the Department expects to receive information have reached settlements.

3 In the private sector the cumulative average has fallen from about 8½% at the start of the round to just over 6½% (283 settlements covering 1,508,000 employees). For manufacturing the average level is about 6% and in non-manufacturing is about 7%. About ¾ of settlements and employees are covered by settlements in a 5% to 8% range. Few settlements are above 10%. About ⅓ of employees secured a reduction in hours and about ¼ benefit from holiday improvements.

4 In the public sector (6 settlements covering 219,000 employees) the cumulative average of just over 11½% is still dominated by the 13.2% increase for Police (138,000).

NEGOTIATIONS

5 In the PUBLIC SECTOR, Coalmining manuals (1 November - 198,000) have voted against strike action on an offer of £102m worth, on average, 9.3% on basic rates (7.4% on earnings). Formal acceptance of the offer by the NUM is expected at a meeting arranged for 26 January. Union negotiators on behalf of UKAEA manuals (1 October - 4,750) have not yet responded to an improved offer of 5% on rates made in reply to a claim for a substantial pay increase. A meeting has been arranged for 26 January. Gas Supply manuals (17 January - 41,300) have submitted a claim for an increase in rates in line with the cost of living and other benefits. Offer of 7% on basic rates and other benefits (about 5.6% on the current paybill) is being considered.

Electricity Supply manuals (17 March - 94,000) have opened negotiations with a claim for a substantial increase in pay, reduction in the working week, longer holidays and other benefits. A reply is expected on 4 February. An improved offer to Municipal Buses platform and non-craft maintenance workers (4 January - 15,200) of 6.6% plus 1 hour's reduction in the working week from November 82 to be partly offset against productivity and two day's extra holiday is being considered. An offer to Local Authority manuals (4 November - 1,077,000) of £4.60 increase on basic rates (6.9% on current paybill) plus a commitment to a 1 hour reduction in the working week from 1 November 82 has been put to members. The GMWU and TGWU have voted to accept. A formal decision is expected on 25 January. A claim by NHS Ancillary workers (1 April - 210,000) for a substantial increase, reduction in the working week and improved holidays is being considered by management and a meeting with the unions is to be arranged soon. The Non-Industrial Civil Service unions (1 April - 508,000) have submitted a joint claim for an increase of 13% with an underpinning minimum increase for adults of £12.50 per week plus improvements in annual leave - estimated to add about 14% on average to basic pay rates. A meeting to discuss the claim is being arranged. Primary and Secondary Teachers E & W (1 April - 460,000) have submitted a claim for increases in line with inflation. A meeting has been arranged for 16 February. The British Steel Corporation (1 January - 108,000) is not prepared to negotiate a national pay award for 1982 and has stated that any pay increases must be linked to productivity deals negotiated at local level. All the unions apart from the ISTC (some 60,000 members), have agreed to accept the proposal but the ISTC are seeking further concessions on hours and consolidation and are calling for an overtime ban from 7 February.

6 In the PRIVATE SECTOR, seventeen of the 21 areas of the Road Haulage Industry (Nov/March - 97,000) have presented claims for increases in pay, holidays and other benefits, estimated to be worth about 50% overall. Five areas have accepted an offer of 6.2% - 7%. Eight areas have rejected offers in the range of 2.5% to 8.6% and there are threats of industrial action in Wales, Tyneside and the London area. Multiple Baking production workers (30 November - 20,000) are to ballot on an 8% offer. The result is expected by the end of January. Unions representing Newspaper Publishers Association production workers (1 January - 33,000) are balloting members on a 5% 'final' offer. The result is expected by the end of January. SOGAT have rejected the offer. The claim is worth about 15%.

Guardian Royal Exchange staff (1 January - 8,700) are considering an offer of 6% plus 1.5% bonus in response to a claim for 12% plus other benefits. Unions representing Talbot Motor Co manuals (1 January - 5,000) are recommending an offer of 2½% on basic rates plus partial consolidation of bonus and 1 extra day's holiday - worth about 5%, also a 1 hour's reduction in the working week from 7 Aug 82. The Engineering Construction Industry (1 January - 20,000) has submitted a claim for 23p per hour increase (8.3%) to give a skilled hourly rate of £3. An offer of 13p new money and 10p consolidation has been made. Negotiations continue over the composition of the increase. Vauxhall Motors Ltd staff (1 October - 5,790) are considering an offer of 5% plus an hour's reduction for staff working 40 hours and 1% for the remainder as compensation. The two unions representing London Clearing Bank clericals (1 April - 146,000) have opened negotiations with claims for 15% increases. The Employers Federation will respond on 28 January.

PRICES AND EARNINGS INDICES

PRICES

7 In December the year on year increase in retail prices was 12.0% the same as in November.

EARNINGS

8 In November the year on year increase in average earnings for the whole economy was 11.3% compared with 11.9% in October.

REAL DISPOSABLE INCOME

9 The real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 3% in the year to October.

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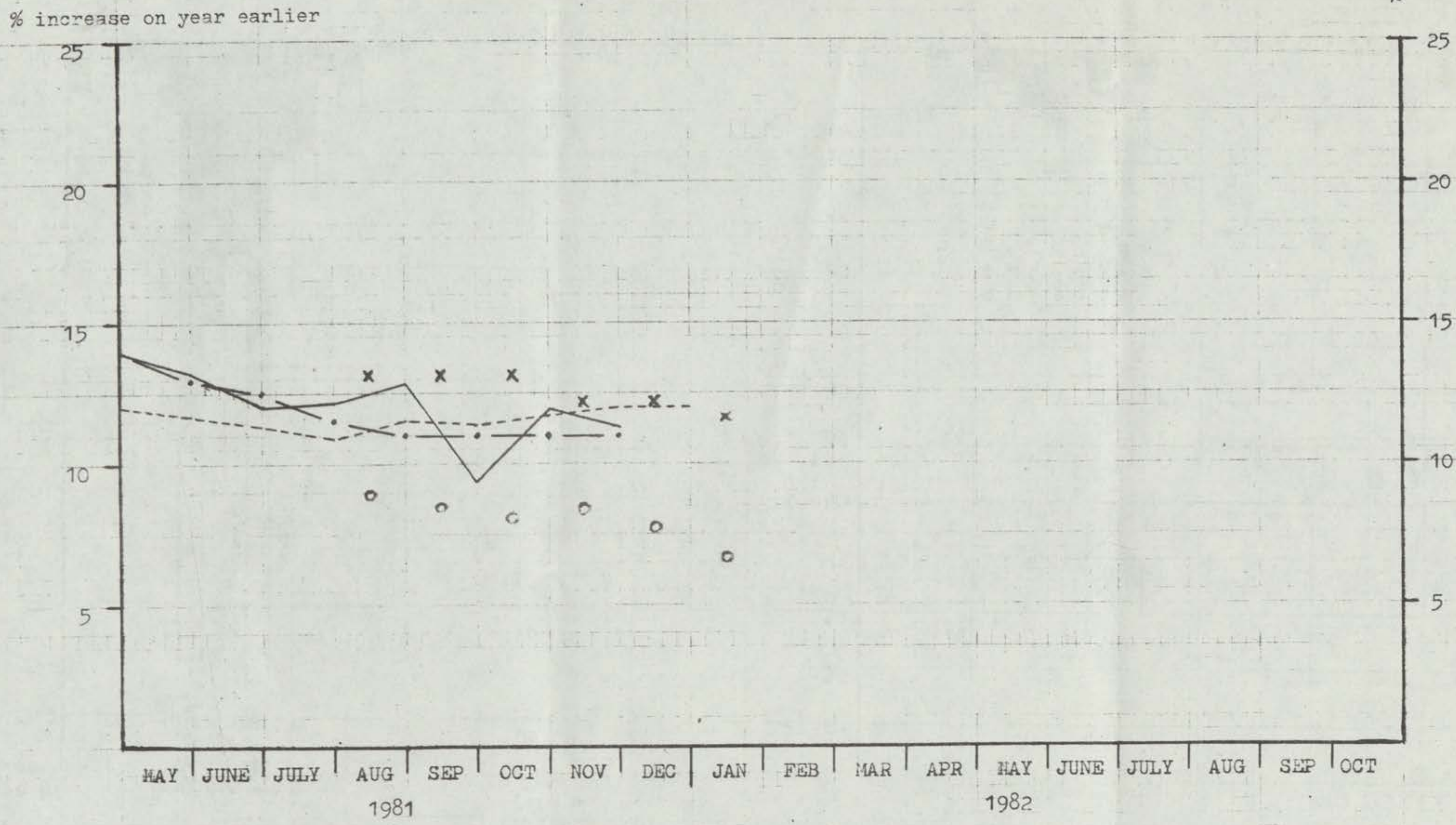
APPENDIX I

TRENDS IN EARNINGS AND PRICES



- - - - Retail Price Index

——— Average Earnings Index (whole economy)

. ——— . Underlying rate of increase in earnings

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× Public Sector Settlements)
o Private Sector Settlements) Cumulative Average Increase in Earnings

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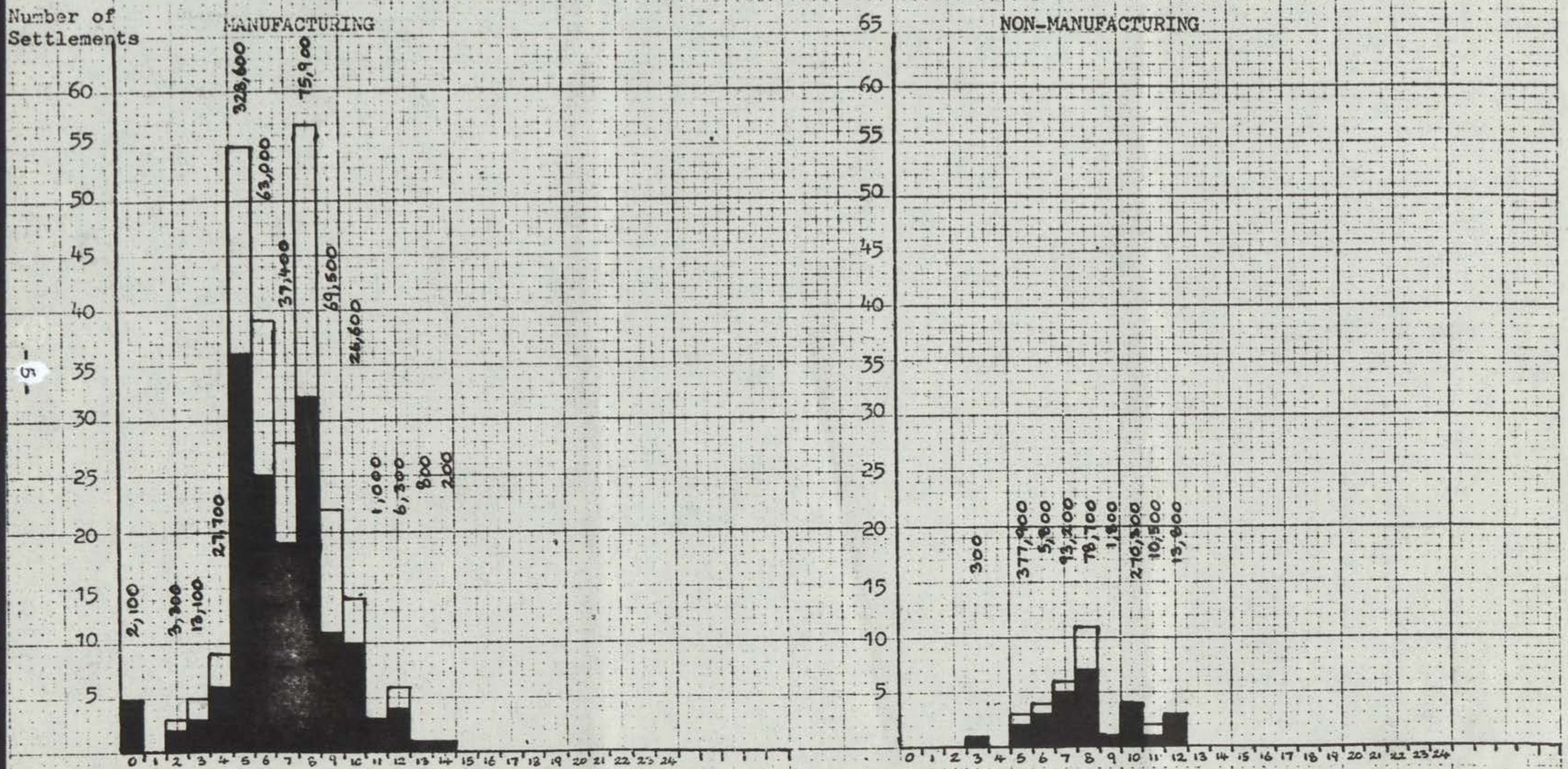
APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981

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

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P7

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 4508

T Burns
Second Permanent Secretary
Chief Economic Adviser

22 January 1982

Dear Michael,

Mr Burns has asked that you should see the attached draft press release of a speech he is to give on Monday 25 January at the Industrial Society.

Best wishes

Yours sincerely

John Hicklin

MPC

Second deletion appears 21-23.

MCS 25/1

Michael Scholar Esq
No 10 Downing St.

SPEECH TO THE INDUSTRIAL SOCIETY SPECIAL CONFERENCE - "PAY THIS WINTER" - Monday, 25th January, 1982

U.K. ECONOMIC POLICY AND PROSPECTS

I will begin today by looking at developments in the U.K. over the past year, first on the policy front, and second in the economy. I will say something about the prospects for the coming year, and, more tentatively, beyond that.

Policy Framework

2. There have been a number of changes in the way in which policy has been operated and presented, over the past year, but the general aim is still that set out in the 1980 MTFS - to reduce inflation, as a necessary part of creating the conditions for sustained growth in output and employment in the medium term. The MTFS described how monetary and fiscal policy would be operated, with this end in view.

3. Of course as is well known annual targets for £M3 have been difficult to meet and I will come to this later. But the Government is still committed to the underlying principle - that steady, but not excessive downward pressure on the rate of growth of monetary variables is an essential element in controlling the growth of money GDP, and finally inflation, over a run of years.

4. The other important aspect of the MTFS is the recognition that fiscal and monetary policy must be operated consistently if monetary control is to be effective without excessive or unsustainably high interest rates. The Government adjusted its PSBR plans last year in view of the depth of the recession. However it has fallen as a

percentage of GDP and it is still an important aim of policy to bring about a substantial reduction in the PSBR as a % of GDP over the medium term.

Progress so far

5. Over the past eighteen months there has been considerable progress in reducing the rate of growth in both money GDP and inflation. The growth in money GDP is now down to about 10% a year, from nearly 20% in 1979/80: the rate of inflation has roughly halved since the Spring of 1980.

6. But as was clear last year output has borne a large share of the adjustment; in turn a large share of the blame for this must be put on the excessive rise in wages in the first eighteen months of the Government's term of office.

Money Supply

7. Despite some difficulties with the growth of £M3 it is clear from developments in the economy generally, and the strength of the exchange rate, that monetary policy, in the broad sense, has been in fact restrictive. Narrow measures of money have grown much more slowly. There are a number of reasons why £M3 alone has not been a good indicator of monetary conditions.

8. In 1980/81 the recession, high wage increases and a strong exchange rate put particular strain on the company sector which responded by cutting stocks and employment, but also by maintaining liquidity through a high level of bank borrowing.

9. Secondly, the move towards greater intermediation by the banks may also reflect uncertainty about inflation which has encouraged transactions in short term financial assets. At least so long as the exchange rate remains firm, these balances may remain a medium for saving rather than spending.

10. £M3 has also been affected by special factors associated with the Civil Service strike and the ending of the SSD Scheme. The latter affected growth in 1980/81 in particular, but may also be behind the continuing rapid expansion in lending to persons this year, especially for house purchase. Some of this business has been won at the expense of other financial intermediaries, notably building societies whose liabilities are excluded from £M3, with the result that £M3 has grown more rapidly than wider measures of liquidity.

Interest Rates

11. I would now like to say something about interest rates. By mid-1980, falling inflation, a high exchange rate, tight pressure on the company sector and a high level of personal saving suggested that further rises in interest rates to bring £M3 back towards the target range would be unwarranted. Indeed, the financial indicators taken as a whole argued for lower interest rates. MLR was reduced in July and November.

12. In the 1981 Budget £M3 was retained as the best single indicator for setting monetary and fiscal policy, and the range for 1981-82 envisaged in March 1980 was set as the target for this year. But the Budget Speech made it clear that the other monetary aggregates, and the exchange rate, would be taken into account in setting short term interest rates and assessing the tone of financial conditions.

13. The 1981 Budget was framed to ease the pressure on interest rates and, indirectly, the exchange rate. The planned PSBR was revised upwards, to take account of the lower expected level of activity. But there was an increase in the burden of taxation on persons - whose living standards had increased rapidly the previous year as pay rose ahead of prices - to make room for some easing in the financial position of companies, through lower interest rates. MLR was reduced by a further two points, at the same time, to 12 per cent, making a total fall of 5 points from the peak rate of 17 per cent.

14. Since the Budget, U.K. financial markets have not been isolated from the surbulence in world markets. The exchange rate fell as oil prices weakened and world interest rates rose steeply ahead of U.K. rates. The authorities willingness to let short rates rise in September and October of this year reflected these external developments, as well as growing concern about the implications of the strong growth in bank lending for the monetary targets. U.K. interest rates have fallen recently but the underlying strength of sterling has meant that the exchange rate has been broadly stable despite rising U.S. rates.

15. It has been extremely difficult to interpret the behaviour of domestic financial indicators this year. Both the PSBR and the monetary aggregates have been heavily distorted by the lengthy Civil Service dispute. As far as one can tell, the PSBR is broadly on track for the Budget estimate of £10½ billion. However £M3 is now some 13% higher than in February 1981, and allowing for the past and prospective effects of the strike, the outturn for the year is likely to be above the top of the target range.

Current Situation and Prospects

16. The forecast published by the Treasury at the beginning of December contained a short assessment of developments through 1981. This pointed to the broad similarity of progress through the year to that projected 12 months previously. Retail prices rose by 12%, compared with a forecast of 11%. GDP at constant prices fell by about 2%, compared with a forecast fall of 1½%. It is worth mentioning also that money GDP over the past 18 months has moved pretty closely in line with the projections that lay behind the first presentation of the MTFS in March 1980.

17. Some developments of course have been surprising - for example, the very large size of the current account surplus in early 1981 and the apparent strength of exports through the year. Consumers' expenditure also held up very well, buoyed by a falling savings ratio. The failure to make quite as much progress in 1981 on inflation can largely be attributed to the fall in the exchange rate. Average earnings have recently been showing increases of about 11% over a year earlier, not much more than half the rate at the end of 1980.

18. There are now signs that the general balance of the economy is improving. Industrial and Commercial companies moved into financial surplus in 1981 whilst there was some fall-back in the disposable income of the personal sector after its previous rapid and probably unsustainable gain. The trough of the recession was passed in the second quarter of last year; the 2% growth of manufacturing output in the third quarter, the rise in GDP and the evidence of higher overtime working and very much less short-time working all bear this out. Our December forecast looked to a growth of 1% in GDP in 1982 and there must be a greater chance of this being exceeded

than the economy falling short of it.

19. Looking at the components of expenditure there is fairly general agreement amongst the various forecasting groups that a slow recovery is now under way, led by a slackening in the pace of destocking or a limited amount of rebuilding of stock levels. Opinions differ on the extent of this, and the stage that has been reached in the investment cycle, but even with only a slow recovery in manufacturing investment, total investment by the private sector should show useful growth this year. Most forecasters see only limited prospects of a fall in inflation over the next few months - largely because of the fall in the exchange rate - but the downward path in inflation should be resumed later this year. Some recovery in profit margins looks likely. A major factor and uncertainty is of course the growth in earnings. A cautious view, consistent with the sketchy evidence we have from the early stages of this pay round, is that some further deceleration will take place; competitive pressures will remain tight and pay bargainers seem to be increasingly aware of the links between wages and jobs.

20. I take the view that we are observing a consistent pattern which starts with exceptional downward pressure on inflation and the exchange rate at a very high level, which is then followed by a period of relative stability as the exchange rate falls somewhat. Thereafter effects of the counter inflation policy and of better pay behaviour will predominate again and we can expect to see further reductions in inflation - this will be evident during the course of this year.

Policy in 1982/83

21. I want to turn now to monetary and fiscal policy over the coming year. The public expenditure planning total for next year shows an increase of about 10% over the planned total for 1981/82, and is about £5b higher than the original plans for 1982/83.

22. On the conventional assumption of indexed tax allowances, thresholds and specific duty rates, and after allowing for the higher national insurance contributions announced by the Chancellor, receipts may rise faster than expenditure, even before allowing for some possible overspill of receipts delayed by the Civil Service dispute. But, obviously, the judgement about the appropriate size of the PSBR next year must wait for the Budget, and will reflect a full assessment of the situation then.

23. ~~Nor can~~ I cannot anticipate the decisions that will be taken then about next year's targets and the presentation of the MTFS. The illustrative range for £M3 for 1982/83 published at the time of the last Budget was 5-9%. This will be reviewed at the time of the Budget, and we are considering what information should be provided about the other financial indicators which are taken into account in setting interest rates. Without anticipating the Budget decisions, however, I think there is a fair presumption that the Government will want to go on looking at a range of financial indicators, including the narrow aggregates and the exchange rate.

The Longer Term Outlook

24. It is difficult to say anything very definite about the prospects for the longer term. There are major uncertainties both about the world outlook and about the extent to which recent

changes in U.K. performance and productivity will lead to an improved trend in productive potential. But I think it is fairly clear that the development most likely to lead to a real recovery in output and employment in the longer term is a further reduction in inflation and costs. It is no coincidence that the major fall in output followed a period when U.K. inflation and wage settlements had accelerated above 20%. Last year inflation fell below 12% and, with higher productivity and lower settlements, wage costs are now rising more slowly than that. Indications are that unit labour costs in manufacturing industry rose very little in the year to Autumn 1981. Again, it is no coincidence that output in manufacturing is showing firm signs of recovery.

25. A further slow-down of inflation and costs would have several beneficial effects.

(i) It would allow interest rates to be lower.

(ii) Business profitability would be improved and this would lead to higher company expenditure - on stocks and fixed investment and also in time on labour. Initially real earnings per hour might be lower but any adverse effect from this on consumer spending has to be set against the beneficial effects from more jobs, more overtime and less short-time working and the further reduction in the saving ratio that lower inflation would be likely to bring.

(iii) Cost competitiveness would improve and with it the prospects for exports and the ability to hold the domestic market in the face of keen competition from imports.

(iv) Finally, there would be improved prospects for an easing of the tax burden within the framework of the financial strategy, which could go either to easing business costs or to increasing real take-home pay.

26. There is only a limited amount that the Government can do to promote these developments. They largely depend on how industry and wage bargainers react. The Government's position is that it must maintain a disciplined financial framework, which will be consistent with a further reduction in inflation. The current growth of money GDP, at around 10-11% is enough to support a satisfactory recovery, provided it is not wholly taken up by higher inflation. The crucial message that the Government is trying to get across is that, within this framework, the faster costs and prices decelerate, the sooner and the faster real activity will recover.

Mr Scholar

ACTION

National Economic Development Council

NEDC(82)6
(For information)

(2)

But Q2 was a record
ave. to the table
MS

Prime Minister

I attach the tables of figures.
I think the reason why the charts
do not seem to indicate a record is
that they have not got the Q3 115.1
figures — not available when the EPR
went to print.

MCS 1/2

ECONOMIC PROGRESS REPORT

Note by the Secretary

I circulate herewith the Monthly Economic Progress Report
by the Treasury for January 1982.

P G Davies

20 January 1982

The output per person
[illegible] does not look a
record for these figures. That
is [illegible] from the figures going
back to 1970. May I have
another look at those figures.

MS.

Economic Progress Report

Published by the Treasury

No. 141 January 1982

Recent trends in labour productivity

In the last 12 months there have been substantial improvements in labour productivity, particularly in manufacturing industry. Between the fourth quarter of 1980 and the third quarter of 1981, output per person in manufacturing rose by almost 10 per cent, and output per person hour by 8 per cent.*

Since the last peak of economic activity in the first half of 1979, output per person in manufacturing has increased by 3 per cent and output per person hour by 6 per cent, against a *fall* of 14 per cent in manufacturing output.

This article poses the interesting question of how to interpret these changes in productivity against the background of what occurred in previous cycles, and asks whether the economy is turning back to the faster trend growth rates in productivity observed in the 1960s.

The short and long terms

In any analysis of this kind it is important to distinguish clearly between long-term, or 'underlying', movements in productivity and short-term movements that may be associated with cyclical changes in output or in the position of the company sector.

One reason for looking at short-term productivity movements is to try and draw conclusions about the long-run growth in productivity. The long run is of interest for two reasons, both of which might indicate an improvement in economic performance.

First, if appropriately defined, labour productivity is analogous to real income per head, which may be a very long-run objective for policy. Secondly, while the productivity of other factors of production is also important, the long-run trend in labour productivity may be a proxy for the long-run growth of technological progress — a measure of how much an economy can grow given the amounts of labour and capital available for production.

This article falls into three parts. The first section outlines movements in productivity since the early 1960s and sets out some possible explanations of the reduced trend growth rate since 1973. The second section examines more closely the movements in employment, output and productivity that have occurred over the last four economic cycles. The final section focuses on developments during the current cycle.

*The figures for output per hour were first published in the December 1981 issue of *Economic Trends*. A full description will be given in the January issue.

Experience in the 1960s and 1970s

Charts 1-3 on pages 2 and 3 show that short-run movements in productivity follow a pronounced cyclical pattern. This is because employers do not fully adjust their labour force to changes in output immediately but respond to such changes only slowly. When output in-

WHAT 'PRODUCTIVITY' MEANS

Productivity is a measure of the quantity of **output** of goods and services that can be produced for a given **input** of factors of production (land, labour, capital, energy, entrepreneurial skills, for instance). A major long-run aim of policy is to increase the standard of living of the community, and raising productivity is the main way of achieving this.

The measurement of productivity

In practice, measures of productivity concentrate on labour rather than other factors of production. This is largely because of problems of measurement. For example, it is extremely difficult to quantify the physical volume of inputs of capital and entrepreneurial skills. Similarly, measures of productivity tend to concentrate on manufacturing industry, because of measurement problems in other sectors. But it should be recognised that labour productivity in manufacturing is only one measure, and not always the best.

Definitions of labour productivity

In official statistics, there are two main definitions of labour productivity:

(i) output per head: the volume of output produced on average by each person employed;
(ii) output per hour: the volume of output produced on average by each person employed, in each hour.

Both of these measures are calculated from indices of output, employment and hours worked, defined in the aggregate, rather than from direct measures of productivity itself. Measures of output per head are published for a number of sectors including manufacturing industry and the whole economy; estimates of output per hour, however, are only published for manufacturing in total.

In the short run, changes in output are usually much larger than changes in employment, which tends to adjust only slowly. Changes in hours worked can usually be made more quickly. As a result, output per head shows a strong tendency to vary with the economic cycle. So too, but to a much lesser extent, does output per hour.

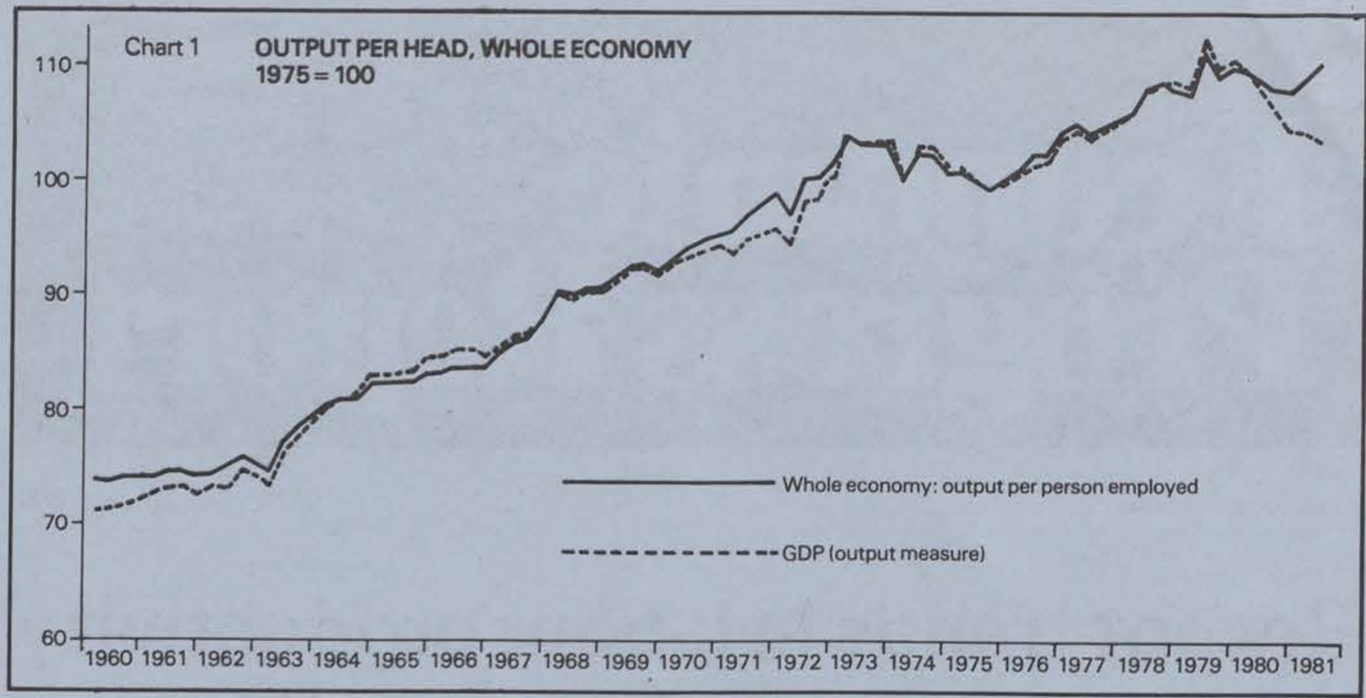


Chart 1 OUTPUT PER HEAD, WHOLE ECONOMY 1975 = 100

creases, therefore, output per head is observed to rise. Conversely, in the downswing of the cycle, falling output implies falling output per head. The first chart presents output per head for the whole economy since 1960 along with movements in aggregate output. The second depicts similar magnitudes for the manufacturing sector alone.

Employers do, however, adjust the average hours worked by their labour force quite rapidly in response to changing output, by varying hours of overtime and short time. Productivity as measured by output per hour therefore tends to exhibit a less pronounced cyclical pattern than output per head. This is illustrated for the manufacturing sector in chart 3. Unfortunately, the data are only available quarterly from 1970. (Lack of reliable average-hours data precludes a comparable measure for the whole economy.)

In all cases these marked cyclical patterns are imposed on a rising long-run trend. For manufacturing, the trend growth rate in output per head was around 3-4 per cent per annum in the 1960s and early 1970s. The trend growth in manufacturing output per hour was perhaps ½ per cent per annum faster over the same period. For the whole economy, trend output per head grew at around 2½ per cent per annum between 1960 and the early 1970s.

Since the mid-1970s there has been a marked slowdown in the recorded growth of productivity. Nearly all industrialised countries suffered a similar deterioration at around the same time, although to varying extents. Despite much research, this change in trend is not well understood. But it seems likely that the successive increases in real energy prices since 1973 have played some part. Investment in energy conservation and fuel switching may have crowded out investment aimed at enhancing labour productivity.

Another possibility is that firms have employed more labour than otherwise as a substitute for highly expensive energy. Other factors may include inflexible labour markets, the more rapid inflation of the 1970s and increased regulatory burdens on industry (for example, health, safety and environmental requirements).

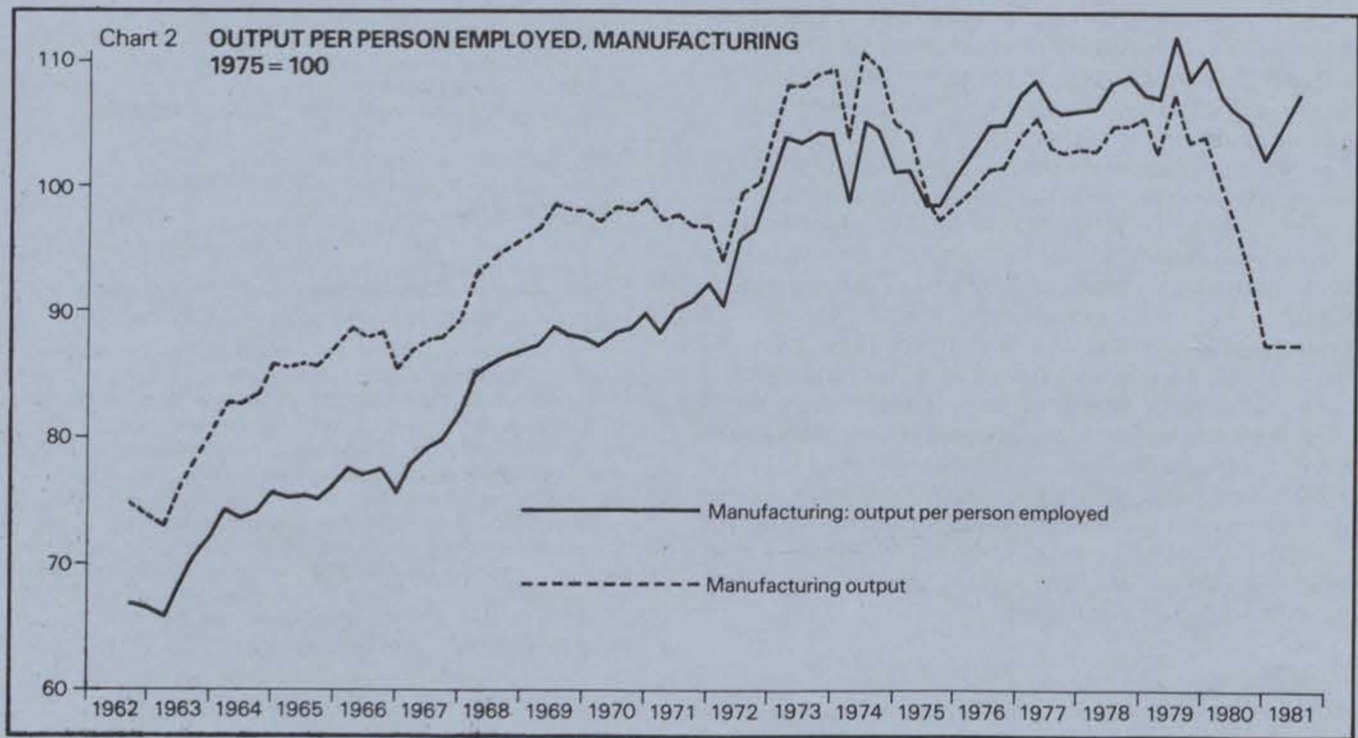


Chart 2 OUTPUT PER PERSON EMPLOYED, MANUFACTURING 1975 = 100

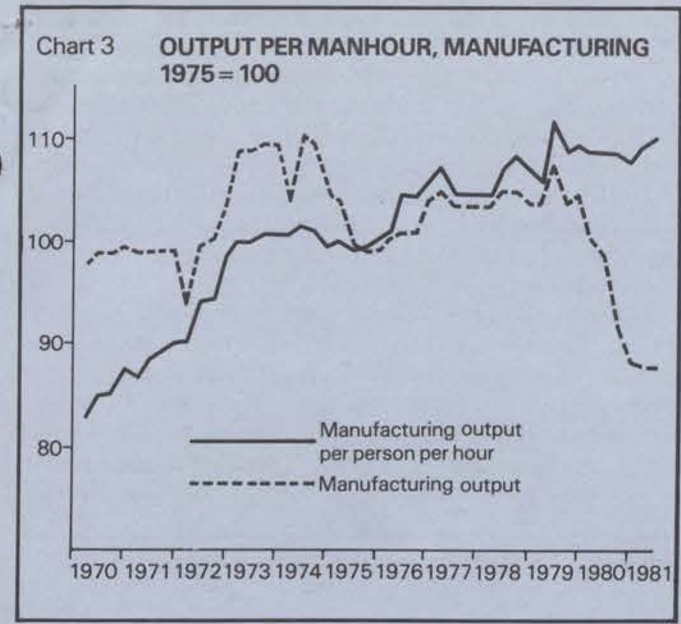


Chart 3 OUTPUT PER MANHOUR, MANUFACTURING 1975 = 100

It may also be that industry expected output to recover more strongly than it did following the recession in 1974 and 1975 and to return to the long-term growth rates, both here and abroad, that were experienced in the previous ten or 15 years*. Firms may have maintained employment levels in the light of these expectations, which, in the event, proved too optimistic.

Manufacturing productivity — the last four cycles

Chart 4 shows movements in manufacturing output, employment and output per head in the last four downturns (starting in 1964, 1969, 1973 and 1979) and the next four to five quarters of recovery. It is clear from the chart that recessions since 1964 have been successively more severe.

In the first cycle (1964-68), a 'growth recession', output actually rose by 1.3 per cent from the peak to the trough of the cycle. However, the second downturn (1969-72) saw a fall in output of 4 per cent, the third (1973-75) a fall of 10.5 per cent and the fourth (1979-81) a fall of 18 per cent.

This is consistent with the general slowdown of the rate of growth of output over the whole period. At the same time, the decline in employment has generally been more severe in successive cycles. Both in the 1964-67 and 1969-72 downturns productivity was broadly stable before recovering strongly in the upturn. A break in this general pattern seems to come in the third (1973-75) downturn. While employment fell at roughly the same rate as in the second downturn, output declined more severely. Consequently, productivity fell sharply, and the recovery in output and productivity was weaker than in previous downturns.

*This hypothesis is supported by a recent National Institute study. See G.C. Wenban-Smith, 'A Study of the Movements of Productivity in Industries in the United Kingdom, 1968-79', *NIESR Review*, August 1981. This paper is part of a wider National Institute study of productivity being financed by the Treasury.

†The exclusion of North Sea oil activities does not greatly affect this calculation although it reduces the level of output per head in 1979 by some 3 per cent (1975 = 100).

While the fall in productivity in 1979-81 was sharper than in any of the previous cycles, it was probably not as severe as might have been expected on past experience, reflecting the much earlier and sharper fall in employment. Compared with the 1973-75 cycle, the pick-up in productivity after the trough (now approximately dated in the second quarter of 1981) has been much stronger, being more in line with the recovery following the 1964-67 and 1969-72 downturns.

An analysis of the current cycle

The last peak in economic activity is officially dated in the second quarter of 1979. But output levels for that quarter were distorted by the recovery from the various strikes in the first quarter. For present purposes, therefore, it is more useful to average the figures for the first and second quarters. Output per head for the whole economy (including North Sea activities) has risen by some 2 per cent from the end of 1980, and in the third quarter of 1981 was slightly above the 1979 first-half level.† In manufacturing, as noted above, there have been substantial improvements in output per head and output per hour since the end of 1980, and, on both measures, productivity in manufacturing is now higher than in the first half of 1979, despite a 14 per cent fall in output.

Interpretation of these recent movements is particularly difficult, since the fall in output from 1979, especially in the manufacturing sector, was greater than in any previous post-war recession. It is, therefore, not clear how reliable a guide to current circumstances past experience may be. But there does seem to be some evidence that

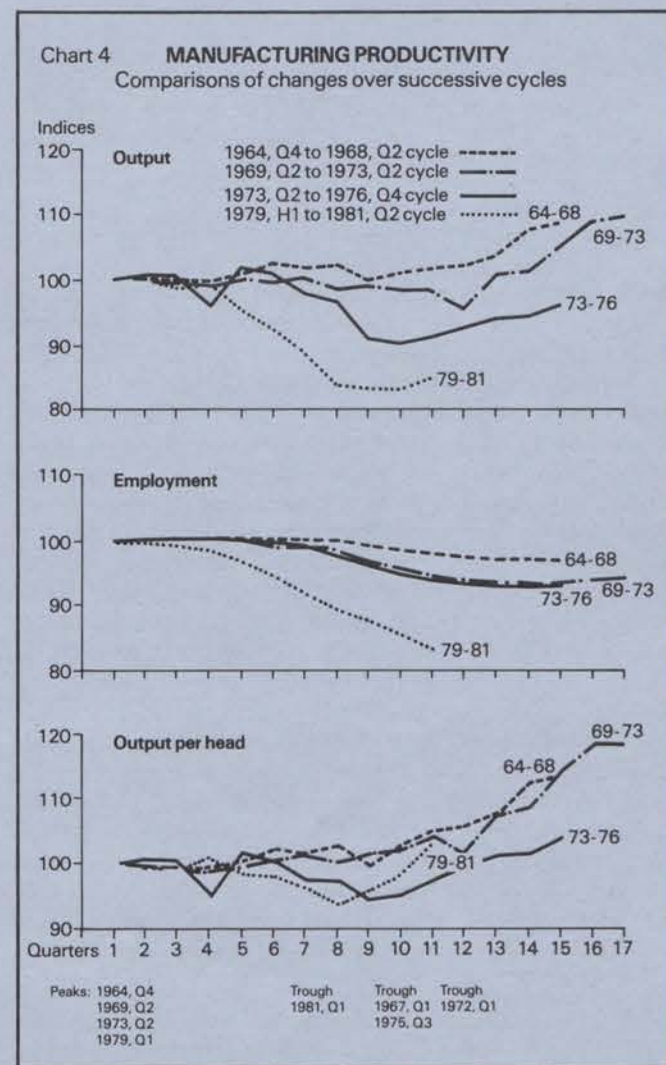


Chart 4 MANUFACTURING PRODUCTIVITY Comparisons of changes over successive cycles

output per head has declined less, relative to output, than in previous cycles. This is shown in charts 1-3.

For example, output per head for the whole economy (chart 1) has tracked movements in output extremely closely over the last 20 years or so. From the end of 1979, however, a marked divergence seems apparent. Productivity fell much less during 1980 relative to output than previous experience would suggest. Furthermore, while output continued to fall in the first half of this year, productivity actually rose. This experience is unprecedented in the past 20 years.

A similar pattern can be observed in manufacturing output per head (chart 2). Again, cycles in productivity and output were closely matched between 1962 and 1979. But the fall in productivity was much less during 1980, and the subsequent recovery much greater, than might have been anticipated given the movements in output. Exactly analogous arguments apply to output per hour in manufacturing.

Chart 5 shows the movements in productivity over the current cycle in four specific manufacturing industries. Particular points to note are as follows:

1. Metals and chemicals have shown a much stronger cycle in output and productivity than manufacturing generally. And the turning point in activity may have arrived earlier than in other sectors, while employment has continued to fall.

2. Of the 10 per cent rise in output per head in manufacturing since the fourth quarter of 1980, metals and chemicals contribute over one third, approximately double their weight in total manufacturing output.*

3. In textiles (and possibly engineering), productivity appears to have held up well (relative to the fall in output) compared with the last cycle, partly reflecting the more intense competitive pressures from imports experienced in these sectors.

Interpretation of recent developments

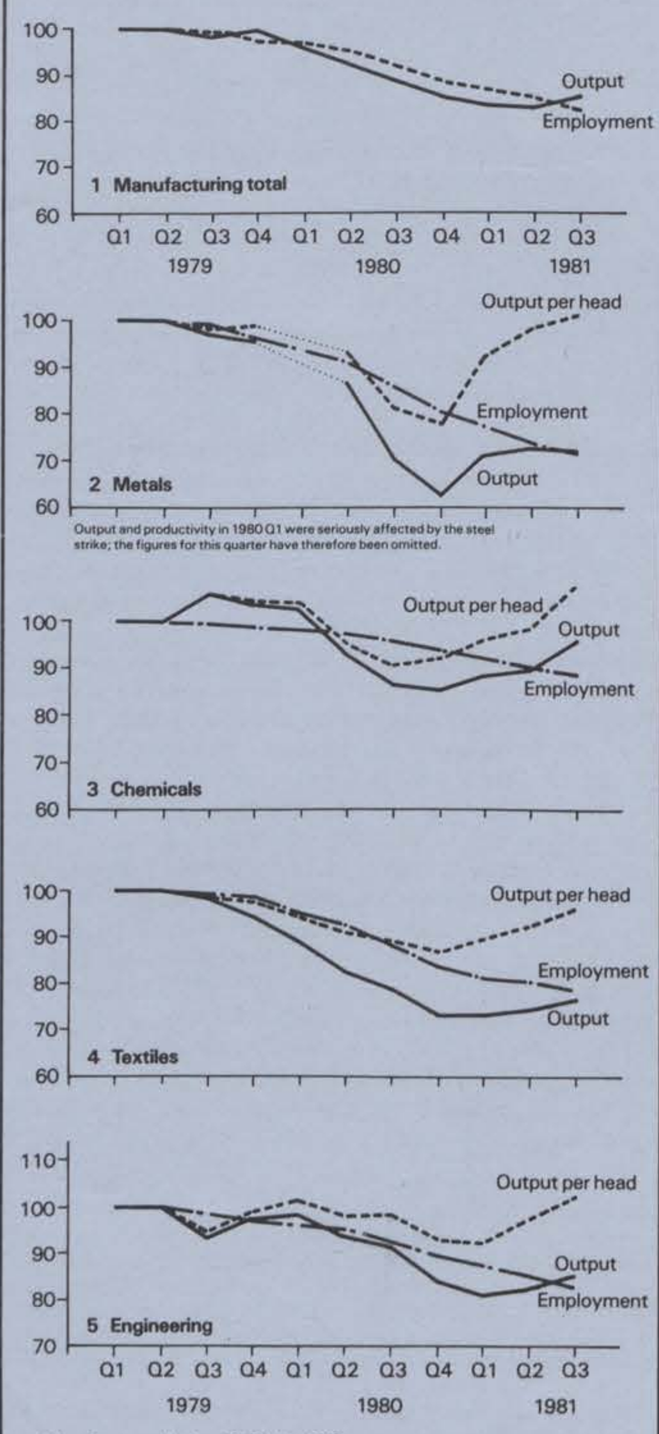
There are enormous problems in trying to separate out short-term and 'underlying' improvements in productivity. The effects of all the various influences on the paths of employment and output over recent cycles cannot be isolated by a simple examination and comparison of these paths. Year-to-year, or even cycle-to-cycle, changes in productivity may tell us very little about the underlying trend. Improvements in labour productivity can reflect a variety of factors — the closure of whole factories or plants, new capital investment or simply the more efficient use of existing capacity. All three factors have probably been important during the current cycle, to varying degrees in different industries, but it is impossible to separate out their effects.

As already noted, one plausible explanation of recent developments is that, on the basis of past experience, firms may have expected an early and rapid pick-up in economic activity after the 1973-75 downturn, and that this (unfulfilled) expectation, together with high redundancy costs and high hiring and firing costs, limited the extent of demanning in that cycle. It may also help to account for the very rapid labour shake-out in the current recession. What we may have been observing recently, therefore, may reflect the unwinding of a long lagged employment response to the disappointingly low output levels of the last cycle and to the real oil shocks of the 1970s. In addition, employers may have shed labour rather earlier and faster than in previous cycles, perhaps reflecting more pessimistic expectations induced by the deep recession and the severe squeeze on the profits and financial position of companies, particularly in manufacturing.

The recent rise in output per head has also been influenced by the recovery in output. Much of the recent increase in manufacturing productivity reflects developments in two industries (metals and chemicals), where output has been undergoing cyclical recovery (albeit from a very low base relative to 1979). There are no indications as yet that these industries are taking on new labour; indeed, their employment levels to October 1981 appear still to be contracting.

*The substantial improvements in labour productivity being achieved at the British Steel Corporation have clearly been an important factor, and provide some measure of the direct impact of government policies on productivity.

Chart 5 **MANUFACTURING PRODUCTIVITY**
Movements in different sectors



All series rescaled to 1979 H1= 100

Conclusion

It is too early to say whether we are witnessing an improvement in the long-term growth of productivity. But expectations of only moderate economic recovery, and the low level of profitability in many companies, should exert pressure to reduce costs and improve efficiency; this reduces the likelihood of any reversal of productivity gains already achieved. Similarly, despite the very slow growth in unit wage costs in manufacturing this year and the fall in the exchange rate, manufacturing competitiveness is probably still some 35-40 per cent below its end-1978 level. So competitive pressures on UK firms remain strong.

It seems possible, therefore, that the recent rise in productivity may be followed by an improvement in the long-term trend. The tendency for companies to substitute capital for labour in response to the higher relative cost of energy and labour inputs is likely to remain. Capital investment, particularly in the private non-manufacturing sector, has remained high. Government policies towards the labour market aim to provide better resource allocation in the future.

Alternatives to domestic rates

The Government published a Green Paper on alternatives to domestic rates as a source of revenue for local authorities in Great Britain on 16 December 1981 (HMSO, Cmnd 8449).

The main features of local government finance in Great Britain are shown in the table.

The Green Paper is a response to public criticism about the way in which local people contribute to the cost of local services. It does not set out firm proposals but seeks to identify the range of realistic alternatives on which consultation can now take place.

Local government finance in Great Britain 1981-82

	£ bn
Gross expenditure	30
Financed by:	
government grants	14.3 (48%)
fees and charges	4.5 (16%)
non-domestic rates	6.1 (20%)
domestic rates	4.8 (16%)

Note: These figures reflect latest information at the time the Green Paper was published.

The main options

The main options identified and discussed in the Green Paper are:

- a local sales tax
- a local income tax
- a poll tax (payable by each resident at a flat rate)
- reforms to domestic rates.

In addition, several other possibilities are rejected:

- local duties on petrol, alcohol or tobacco
- local vehicle excise duty
- charges for licences for the sale of alcohol or petrol
- a local payroll tax (payable by employers on each employee).

Seven criteria

Each potential local tax is assessed against seven criteria:

- is it practicable?
- is it fair?
- does it make councillors who make decisions on local expenditure properly accountable to the local taxpayers?
- are the administrative costs (both for tax gathering and taxpayers) acceptable?
- are the implications for the rest of the tax system acceptable?
- does it encourage proper financial control?
- is it suitable for all tiers of local government?

Separate chapters in the Green Paper consider each of the serious alternatives in turn. Local rates confine the local tax burden to occupiers of property with an unevenly distributed burden across the country; on the other hand, the tax base is relatively easy to identify.

Income and poll taxes

A local income tax would spread the tax burden wider: and an individual's tax liability would be related more closely to his ability to pay; but it would be complex to administer. As with local income tax, local sales taxes would achieve a broader local tax base at the expense of imposing significant costs on traders. Both local income tax and local sales taxes would have unpredictable yields, and, because they could share a tax base with central government, there could be some conflict with the Government's fiscal objectives.

A poll tax would spread the local tax burden without the complication of sophisticated measurement of ability to pay, but could be difficult to enforce and would be open to criticism as taxing the right to vote.

Government grants

The Green Paper also considers changes in the system of government grants which could result from a switch to a new local revenue. At the extreme, it might be possible to replace the revenue from domestic rates by extra rate support grant (RSG), but an equivalent amount would have to be realised by the central government in some other way. Moreover, removing the link between local expenditure decisions and local taxation would tend to damage public accountability and local autonomy.

Another section of the paper covers the economic effects of changing the local tax system, including the financial consequences for some typical households in different parts of the country.

Open mind

The Government have an open mind about the way in which reform should be achieved. Some taxes would be unsuitable for both counties and districts. Some would not be flexible or predictable enough to replace rates on their own. Most would work better if supplemented by other taxes — rates or poll tax at district level, for instance, to accompany a sales tax for counties.

Because the Government attach importance to reforming the domestic rating system as a matter of urgency, comments are invited by the end of March.

UK overseas assets and liabilities

There has been a substantial improvement in the United Kingdom's net balance sheet over the past five years.

Current account surplus

Traditionally, the UK's overseas assets have exceeded liabilities abroad. By 1975 there was a position of near balance. The improvement since then in part reflects valuation changes; but in 1978 and especially in 1980 there was also a substantial surplus on current account. The proceeds of the surplus, which was helped by the growth of North Sea oil production, went to build up overseas assets or reduce overseas debt.

In the period 1978-80 there was a current account surplus of £3.2 billion, compared with a deficit of £5.8 billion between 1973 and 1975. Table 1 and the chart show the deterioration in the position up to 1975; and the improvement between the end of 1977 and the end of 1980. With a substantial current account surplus expected in 1981 there should have been a further improvement since the end of 1980.

UK EXTERNAL ASSETS AND LIABILITIES 1970-1980

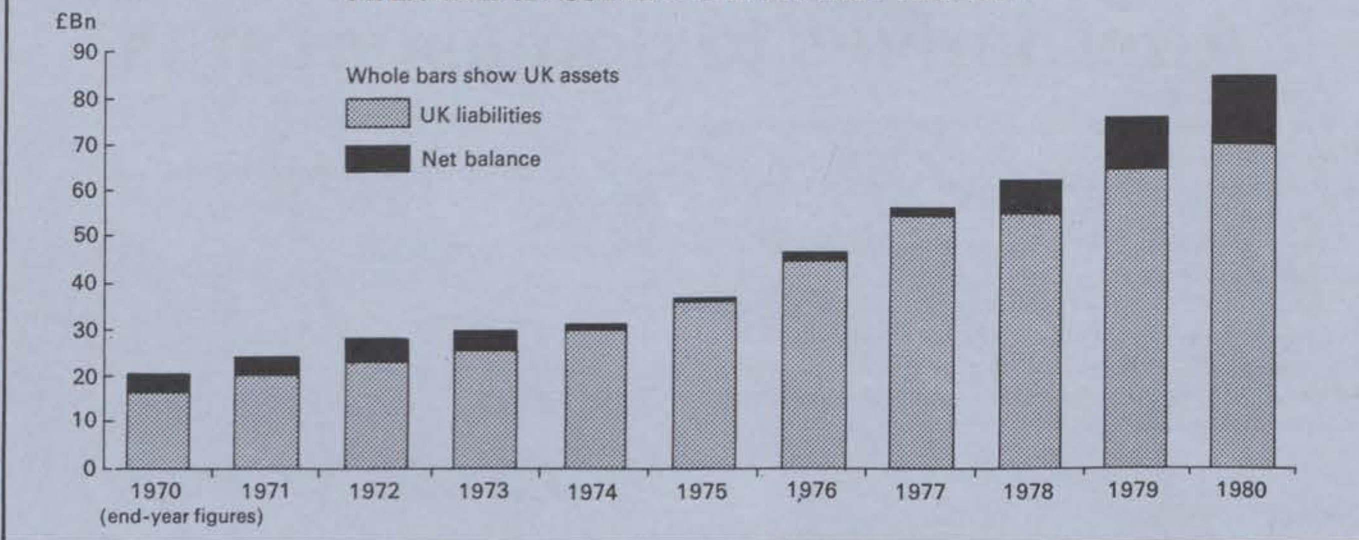


Table 1 UK external assets and liabilities

end-year figures
£ billion

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
External assets	20	24	28	30	31	37	46	56	62	73	85
External liabilities	17	20	22	25	30	36	44	54	54	62	70
Net balances	**4**	**4**	**6**	**5**	**1**	**1**	**2**	**2**	**8**	**11**	**15**

Notes:
1. Direct investment is at book values; portfolio investment at market values; property investment is excluded because of lack of figures.
2. For further notes see: *UK Balance of Payments 1981*, CSO, tables 11.1 and 11.2.
3. In tables 1 and 2 figures do not necessarily add, because of rounding.

There are difficulties in identifying and measuring outstanding stocks of both assets and liabilities, so that the net position is subject to particularly wide margins of error.

Public and private sectors

The figures show a net improvement since 1977 of around £13 billion. Table 2 shows that over a third of this was in the public sector's position, as official foreign currency reserves were built up and official overseas debts repaid. The rest reflects the balance between private investment overseas and overseas investment in the UK private sector. In contrast, figures for earlier years show that the UK's net holdings of overseas assets declined between 1972 and 1975 as the Government increased their overseas borrowing. The low value of sterling in 1976 increased the sterling value of both net private sector assets and net public sector liabilities denominated in foreign currencies.

Table 2 UK overseas assets (net of liabilities)

Balance, end-year
£ billion

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Private sector	+7	+4	+7	+6	+4	+5	+10	+4	+9	+8	+12
Public sector	−3	0	−1	−1	−3	−4	−8	−2	0	+3	+3
Total	**+4**	**+4**	**+6**	**+5**	**+1**	**+1**	**+2**	**+2**	**+8**	**+11**	**+15**

Since exchange controls were abolished in 1979 it has been easier for the private sector to invest overseas and increase the UK's holdings of profitable overseas investment. These overseas assets will produce foreign currency earnings in future, which should continue to benefit the current account after the value of North Sea oil production has begun to decline.

There has, in addition, been a sizeable improvement in the net foreign currency position of the public sector. The reserves have been built up and the Government have made progress with the repayment of official external debt. Table 3 shows this more clearly. (Official reserves and official external debts only account for part of the public sector figures in tables 1 and 2.)

Table 3 Official reserves and foreign currency debt

$ billion (end-year)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Official foreign currency debt	5.2	7.8	12.3	14.0	19.3	24.5	23.4	20.9	17.5	13.3
Official reserves	5.6	6.5	6.8	5.4	4.1	20.6	15.7	22.5	27.5	23.3

Source: *Financial Statistics*, December 1981. See footnotes to tables 11.4 and supplementary table B, June 1981 issue.
Note: These amounts are valued on a different basis from those in tables 1 and 2.

EUROPEAN COMMUNITY BUDGET REFUNDS

On 22 December 1981 the Commission adopted decisions granting the balance of the UK's Community Budget refunds for 1980. As a result, the UK is to receive a further £109 million, which will bring its total gross refund receipts for 1980 to £799 million (1,438 million ecus). The UK contributes to these gross receipts, as to other Community expenditure, and the corresponding total of net receipts is 1,175 million ecus, as provided in the Council agreement of 30 May 1980 (see *Economic Progress Report*, July 1980).

The Commission's latest decisions have two components:

(i) repayment by the UK of the instalment received last January under the financial mechanism and,
(ii) further payments to the UK under the supplementary measures scheme.

When the Commission's final estimates for 1980 were compiled, the UK's share of gross contributions to the Community Budget turned out to exceed its estimated share of Community gross domestic product by a little less than 10 per cent. The UK therefore failed to qualify for the financial mechanism and had to repay the instalment of some £211 million received under the financial mechanism last January. In accordance with the 30 May 1980 agreement, this sum has now been paid under supplementary measures instead.

The total sum to be received under the latest decision on supplementary measures is £319.7 million (563.3 million ecus). This comprises net additional payments of £109.2 million as well as the £210.5 million (351.75 million ecus) previously received under the financial mechanism and now transferred to supplementary measures.

The supplementary measures scheme provides for contributions by the Community in respect of public sector investment programmes in the UK, principally in the regions. For details of the regional programmes attracting support under the scheme see *Economic Progress Reports* for January and May 1981. The Commission's latest decisions provide in addition for a Community contribution in respect of the Department of Transport's trunk roads programme. Projects which form part of this programme include sections of the M25 orbital motorway around London, the A45 Ipswich bypass, the M54 from Telford to the M6 and the A40 Gloucester Northern bypass.

The table shows total Community contributions under the supplementary measures scheme for 1980-81 programmes of public sector investment in the UK.

The Community Budget refunds are enabling public expenditure programmes generally in the UK to be sustained at levels higher than the country could otherwise have afforded. Expenditure programmes throughout the country are benefitting accordingly. The refunds do not, however, open the way to increases in domestic expenditure programmes beyond the levels already planned. These planned levels were set on the assumption that substantial refunds would be received from the Community Budget.

The 30 May agreement provides that refunds for a particular year should be paid from the Budget of the following year. It also provides for the possibility of speeding up payment under supplementary measures. The 1981 Community Budget made provision accordingly for advance payments to the UK of 150 million ecus, and the Commission put forward to the Council a proposal for advance payments of this amount. Since, however, the Council did not act on the Commission's proposal before the end of 1981, the Commission are now expected to propose accordingly that the provision be carried forward into 1982. The Commission and the Council are committed to providing not less than 80 per cent of the UK's supplementary measures entitlement for 1981 by the end of March 1982.

COMMUNITY CONTRIBUTIONS IN RESPECT OF UK PUBLIC SECTOR INVESTMENT PROGRAMMES, 1980-81

£m

	Northern England	North-West England	Yorkshire & Humberside	South-West England	Scotland	Wales	Northern Ireland	Trunk roads	Total
Roads	16.8	27.3	9.5	—	37.0	41.2	25.6	103.0	260.4
Rail	9.6	17.0	19.8	3.7	24.4	7.1	1.2	—	82.8
Water and sewerage	20.2	24.6	22.7	5.3	—	9.2	10.9	—	92.9
Advance factories	—	0.9	—	—	7.2	12.4	2.5	—	23.0
Land reclamation	—	—	—	—	3.6	—	0.2	—	3.8
Tele-communications	33.6	64.5	69.3	13.8	56.4	47.8	33.0	—	318.4
Housing	—	—	—	—	—	—	17.8	—	17.8
TOTAL	80.2	134.3	121.3	22.8	128.6	117.7	91.2	103.0	799.1

The index of average earnings

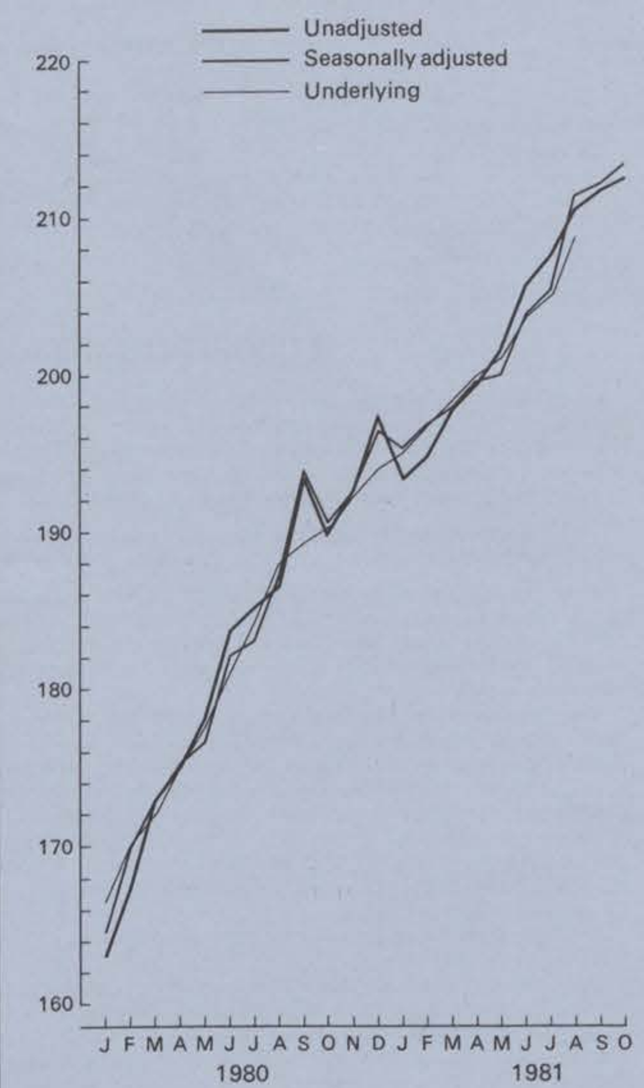
Confusion sometimes arises over the different forms in which monthly indices of average earnings have been made available in recent years. This note describes how the present situation has developed.

The first average earnings index, started in January 1963 and later rebased on January 1970, covered only the production sector and a limited range of other industries (road, rail and air transport, laundries and dry cleaning, shoe repairing and motor trades): it omitted most of the service sector, accounting for about half of all employees.

In January 1976 a new index was introduced which covered virtually the whole economy. For the sake of continuity the older series was maintained for an interim period, but was finally discontinued at the end of 1980. For those industrial groups which appear in both the new and the older indices, a continuous series back to 1963 can be obtained by linking the relevant parts of the two sets of indices.

AVERAGE EARNINGS INDEX FOR GREAT BRITAIN (WHOLE ECONOMY)

Jan 1976 = 100



Sources

Like its predecessor, the present index is constructed from information obtained by the Department of Employment through a monthly survey of a representative sample of firms in Great Britain, together with information supplied by the Ministry of Agriculture about agricultural earnings in England and Wales. Returns cover some 10 million employees. The average weekly earnings for each industry group are weighted together using estimated numbers of employees in employment, and the result expressed as a percentage of the corresponding figure for January 1976. The employment weights are revised at the beginning of each year.

Publication

Separate indices are published for each Order group of the Standard Industrial Classification, and for two broader aggregates — manufacturing and production industries. The full detail is published first in the *Employment Gazette* of the Department of Employment (two months after the date to which it relates), and shortly afterwards in the Central Statistical Office's *Monthly Digest of Statistics*. Figures for the whole economy, and for the aggregates mentioned, are published about a fortnight before the *Employment Gazette* appears, in a Department of Employment press notice. The whole economy index also figures in the table of economic indicators which appears, when space permits, in *Economic Progress Report*. (See opposite page.)

Seasonal adjustment

For each individual industry Order group an index of actual earnings is published each month. The broader indices are also available in seasonally-adjusted form, taking account of variations in earnings which take place with some regularity each year. For example, earnings are generally somewhat below trend in August because of holidays, and above trend in December because of Christmas and end-year bonuses, high overtime payments and so on.

In the case of manufacturing and production industries (and the 'older series' as a whole when this was compiled) such adjustments are reasonably effective in smoothing out short-term variations in earnings. For the economy as a whole they also serve some purpose in lessening the peaks and troughs in the most affected months, and in removing a general tendency for earnings to increase faster in the second and third quarters of the year than in the remainder (reflecting a concentration of settlement dates in this period).

However, the whole economy index, even when seasonally adjusted, remains subject to large short-term variations, principally because of differences between one year and another in the timing of pay settlements. The seasonal adjustment allows for an *average* pattern of timing; but if, for example, settlements are unduly delayed in a particular year, the index will be depressed for a period and may then be temporarily inflated by lump-sum payments of arrears. Examples of this can be seen in the chart, which shows the figures for 1980 and 1981. The peaks in the actual index in September and December 1980 reflect large payments of arrears to (respectively) teachers and local authority non-manual staffs, both of which groups settled much later than usual that year. A conventional seasonal adjustment does nothing to remove such fluctuations. Other factors not allowed for by seasonal adjustment include the depressive effects on earnings of industrial disputes and of holidays such as Easter which do not occur at the same time every year.

In an attempt to quantify the impact of these irregular influences, the Department of Employment have for the last two years compiled an 'underlying' index of average earnings which seeks to measure how earnings would have changed if the normal timing of pay settlements had been followed. This involves subtracting from the seasonally-adjusted index any unusually large amounts of back-pay, and adding in allowances for earnings lost through industrial disputes, non-recurring holidays and so on. Such adjustment inevitably involves an element of professional statistical judgement and can only be approximate: the methodology for it is described in an article in the April 1981 issue of the *Employment Gazette*.

The underlying index

The underlying index is shown in the chart. At certain times it can give a more helpful indication of the trend change in earnings than the seasonally adjusted index. Its main use is not primarily for long-term comparisons (for which users can make their own estimates of trend by taking a run of months together) but as an aid to interpreting the figures for a short run of recent months.

In view of its essentially short-term value the underlying index is not published as a regular statistical series, but is presented from time to time in the *Employment Gazette* (most recently in the November 1981 issue). Percentage changes in the underlying series over the latest 12 months are given in the Key Statistics Commentary in the *Employment Gazette*.

Summary

To summarise, the unadjusted average earnings index measures changes in average cash payments made to employees based solely on employers' returns. The seasonally-adjusted index removes the effect of regular recurring variations but is still subject to temporary influences such as back-pay, industrial disputes and the timing of settlements, which can be substantial. The underlying index allows for these too in an approximate way but is intended only as a supplement to the other indices for purposes of short-term comparisons.

READERS' ENQUIRIES

Distribution enquiries

Copies of *Economic Progress Report* are available from Publications Division, Central Office of Information (COI), Hercules Road, London SE1 7DU. Readers who receive their copies direct from COI are asked to notify any change of address or of requirement.

Editorial enquiries

Communications about the contents should be addressed to the Editor, *Economic Progress Report*, Information Division, HM Treasury, Parliament Street, London SW1P 3AG.

Economic indicators[1]

(seasonally adjusted)

PUBLISHED MONTHLY (months or monthly averages)	Unit	1980	1980 3rd qtr	1980 4th qtr	1981 1st qtr	1981 2nd qtr	1981 3rd qtr	1981 Oct	1981 Nov	
1 Industrial production	1975=100	105.3	103.5	100.9	99.7	99.1	100.2	102.3	—	1
2 Unemployment (excl. school-leavers)	000s	1,647.6	1,699.0	2,019.8	2,304.4	2,506.4	2,627.1	2,728.9	2,764.3	2
3 " " " "	% of all employees	6.8	7.0	8.3	9.5	10.4	10.9	11.3	11.4	3
4 Retail sales (volume)[2]	1976=100	109.4	108.9	109.1	112.8	111.2	110.4	112.1	110.5	4
5 Exports f.o.b.[3,6]	£m	3,949	3,902	3,964	—	—	—	4,550	4,765	5
6 Imports f.o.b.[3,6]	£m	3,851	3,696	3,542	3,345	—	—	4,184	4,739	6
7 Balance of payments current balance[6]	£m	+260	+308	+705	—	—	—	+532	+193	7
8 £'s effective exchange rate (average for month)	1975=100	96.1	96.7	100.2	101.4	97.8	90.6	88.2	90.1	8
9 Official reserves[4] (end of period)	$m	27,476	27,637	27,476	28,212	25,631	23,696	23,316	23,463	9
10 Money supply: Sterling M3 (end of period)	£m	66,900	63,800	66,900	68,010	70,850	74,580	75,780	76,110	10
11 Retail prices[4]	Jan 1974=100	263.7	268.9	273.9	280.4	294.0	299.1	303.7	306.9	11
12 Tax and price index[4]	Jan 1978=100	132.8	135.5	138.4	142.2	152.4	155.4	158.2	160.1	12
13 Average earnings (prod. industries)[2]	Jan 1976=100	183.9	189.4	193.2	200.0	203.0	213.0	217.4	—	13
14 Average earnings (whole economy)[2]	Jan 1976=100	182.0	188.1	193.3	196.7	201.1	209.6	213.4	—	14

PUBLISHED QUARTERLY	Unit	1980	1980 1st qtr	1980 2nd qtr	1980 3rd qtr	1980 4th qtr	1981 1st qtr	1981 2nd qtr	1981 3rd qtr	
1 Output (gdp) at constant factor cost	1975=100	107.2	109.7	108.1	106.3	104.7	104.2	103.8	104.5	1
2 Manufacturing industry's fixed capital expenditure	£m 1975 prices	3,578	959	918	893	808	781	761	717	2
3 Consumers' expenditure	£m 1975 prices	71,454	18,104	17,702	17,762	17,886	17,956	17,872	17,760	3
4 Balance of payments, current balance[6]	£m	+3,122	+63	+21	+924	+2,114	—	—	—	4
5 Balance of payments on invisible account	£m	+1,944	+448	+343	+304	+849	+1,323	+659	+303	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 December were 2,781,600 (11.5 per cent of all employees). 6. Owing to industrial action, figures for March-August 1981 are not available.

Monthly Economic Assessment

Prepared by the Treasury on the basis of statistics† available up to 5 January

- **Latest figures confirm that total output is now rising, with recovery concentrated in manufacturing.**
- **Manufacturing productivity (output per head) rose 10 per cent between the fourth quarter of 1980 and the third quarter of 1981.**
- **Non-oil export volumes have regained their level of early 1980, despite the earlier loss of competitiveness and the world recession. However, the propensity to import has risen further.**
- **The latest Department of Industry investment intentions survey points to a modest recovery in capital expenditure in manufacturing, and to continuing growth in the distributive and service industries this year and next.**
- **Following a steep decline, company profitability has now begun to recover.**
- **Retail prices rose by 12 per cent in the year to November 1981.**

Financial developments

In the banking month of December, **sterling M3** increased by around ¼ per cent after seasonal adjustment. Recorded growth over the first ten months of the current target period has now been about 12¾ per cent — equivalent to around 15½ per cent at an annual rate‡. The figures continue to be significantly affected by the recovery of taxes delayed by the civil service strike. Bank lending is still growing rapidly.

Interest rates were steady in the second half of November (the first two weeks of the banking month of December), but on 3 December the clearers cut their base rates by ½ per cent to 14½ per cent. Three-month rates had for some time been consistent with such a reduction. The present level of base rates compares with 14 per cent from the end of November 1980 to Budget time in March 1981, 12 per cent over the spring and summer, and 16 per cent in early October. In the gilt-edged market, yields on short-dated stocks were little changed, fluctuating over the banking month of December as a whole around 15¾ per cent (13¼ per cent in early 1981, 17 per cent last October). Yields on longs hovered around 15¼ per cent, (14 per cent in early 1981, 16 per cent last October), ending the month marginally higher.

Government borrowing figures remain severely distorted by the effect of the civil service dispute on receipts of tax and national insurance. In the eight months to November last year the central government borrowing requirement (CGBR) was about £9¼ billion, about one third of which was due to the civil service dispute. Thus the underlying figure was about £6 billion, much lower than the £10¾ billion for the same period in the previous financial year.

Sterling dropped sharply in mid-December on news of a fall in international oil prices, and, although it subsequently regained some of its losses, its recovery was stunted by the strength of the dollar, which reflected the renewed increase in US interest rates. Over the month, sterling fell from an opening level of $1.96 (92.0 effective) to $1.91 (90.9 effective) at the end. This compares with $2.31 (101.4 effective) in the first quarter of 1981.

Inflation and costs

The rate of price inflation, as measured by the 12-monthly increase in the **retail prices index*** (RPI) in November was 12.0 per cent. The recent rise in mortgage rates and higher food prices increased the RPI in November by about ½ per cent, and there will have been a further effect in December.

Following their stabilisation in October, **manufacturers' input prices*** fell by ½ per cent in November. This reflects a fall in the cost of imported raw materials and fuels (as sterling rose against the dollar), partially offset by higher coal, electricity and dollar oil prices. **Manufacturers' output prices*** rose by 11 per cent in the year to November.

Average earnings of employees in Great Britain increased by 11.9 per cent in the year to October. After allowing for the uneven timing of settlements and other temporary factors such as back-pay, the underlying increase of around 11 per cent in October was much the same as in September. So far, too few pay settlements have been made to discern the general trend in the current pay round as compared with the previous round.

Entirely reflecting the 2 per cent rise in output and 7 per cent fall in employment between the fourth quarter of 1980 and third quarter of 1981, **manufacturing productivity**§ (output per head) increased by 10 per cent over the same period. Reflecting this and lower pay settlements, unit wage and salary costs in manufacturing were broadly unchanged earlier in the year and rose only gently in the summer. The 12-monthly increase in **manufacturers' wage and salary costs per unit of output** fell to 4 per cent in September.

The moderation of unit labour costs and the earlier fall in the exchange rate have led to an improvement in labour cost competitiveness, probably of over 10 per cent so far. **Gross trading profits** (net of stock appreciation) of industrial and commercial companies rose by about 10 per cent between the second and third quarter of this year, and have now been rising since the end of 1980. Excluding North Sea oil and gas activities, gross trading profits, which were broadly unchanged between mid-1980 and mid-1981, also showed some improvement in the third quarter.

†All figures are seasonally adjusted unless marked *

‡Cumulative growth rates for other monetary aggregates, adjusted for the widening of statistical coverage which took place in November, are not yet available.

§For a detailed discussion of productivity see article on 'Recent trends in labour productivity' on page 1.

Economic activity

Revised estimates of **GDP (output)** — usually regarded as the best indicator of short-term movements in activity — showed a rise of about ½ per cent in the third quarter over the second quarter. The rise in output was concentrated in industrial production, with little change in other sectors (see table 1). Most of the fall in output since the first half of 1979 (the peak of the last economic cycle) occurred in manufacturing and construction. Mineral oil and natural gas production had a substantially higher level of output in the third quarter of last year than in the first half of 1979, and output in the rest of the economy held up comparatively well.

Table 1 **Recent movements in output**

	1975 weights	% change 3Q 1981 on 2Q 1981	% change 3Q 1981 on 1H 1979
Industrial production:			
Manufacturing	283	+2½	−14
Construction	74	+2½	−15
Mineral oil and natural gas§	0.1	+1	+14½
Other industries†	50	−2	−4
Total	**407**	+2	−11
Rest of the economy‡	**593**	0	−1½
Total output**	**1000**	+½	−5

§Exploration for, and extraction of mineral oil and natural gas (and condensates) on land and offshore.
†Gas, electricity and water, and mining and quarrying (excluding natural gas and North Sea oil).
‡Agriculture, forestry and fishing, transport and communications, distributive trades, public services and other services.
**Gross domestic product, output based.

Latest (October) industrial and manufacturing production figures confirm the general trend in the third-quarter figures. Within manufacturing, the recovery has been fairly widely spread across most sectors, with a strong (and early) recovery in chemicals.

The major reason for the turnround has been that industries are increasingly meeting demand from higher output, and very little from running down stocks. Revised figures show that **destocking in the manufacturing and distributive industries** in the third quarter ran at only one fifth of the rate in the previous 18 months (see table 2).

Table 2 **Change in stocks held by manufacturers and distributors**

£m, 1975 prices, seasonally adjusted

1979 (whole year)	1980 Q1	1980 Q2	1980 Q3	1980 Q4	1981 Q1	1981 Q2	1981 Q3
740	−430	−220	−390	−840	−400	−560	−100

Consumers' expenditure in real terms has been maintained; in the first three quarters of 1981 it was unchanged from the average level in 1980, and slightly higher than in 1979. Retail sales, although showing an erratic monthly pattern, were, on average, in the 11 months to November 1981, 2 per cent up on 1980.

Investment

The total volume of **fixed investment** and, within this, the volume of investment in the manufacturing, distributive and service (MDS) industries have been broadly stable, though somewhat below the average for 1980. There has been a large fall in investment in housing and other buildings; but investment in plant and machinery has held up comparatively well (see table 3).

Table 3 **The volume of investment, by type of asset**

Per cent change, average of first three quarters 1981 on year 1980

	Total investment	Housing	Other new building	Vehicles ships and aircraft	Plant and machinery
Whole economy	−7¾	−22½	−4½	−20½	−1
MDS	−4½	−15		−2½	−2

In the whole economy, investment in plant and machinery in the first three quarters of 1981 was only marginally lower than in 1980, despite a fall in the total volume of investment, and was some 9 per cent higher than in the first half of 1979, the peak of the last economic cycle.

The decline in MDS investment has not been evenly spread. In the period covered, the volume of investment in the distributive and service industries increased by 2½ per cent; this was offset by a fall of 17 per cent in manufacturing investment. This largely reflects the decline in manufacturing output, but also the increasing importance of leasing. Preliminary estimates of investment in manufacturing for 1981 suggest that the volume of leased assets (mainly plant and machinery) will total £670 million (in constant 1975 prices), or almost 20 per cent of total manufacturing investment. This compares with 10½ per cent in 1979, and only 5 per cent in 1975. Even so, including leasing, investment in manufacturing is estimated to have fallen 13 per cent between 1980 and 1981.

Investment prospects

The latest Department of Industry **investment intentions survey** supports the view that total investment in MDS has stabilised in 1981, and points to a 2 per cent increase in 1982, with a larger increase in 1983. The survey also sees some recovery in manufacturing investment during the course of 1982. The recovery is, however, liable to be more than offset by further falls in the first half of 1982, and, overall, it is estimated that the volume of manufacturing investment, including leased assets, will be slightly lower in 1982 than in 1981.

Labour market developments

Despite the recent pick-up in manufacturing output, **total employment in manufacturing** continues to fall, although at a slower rate. In the three months to October, total employment in manufacturing in Great Britain fell by an average monthly rate of about 28,000 per month, compared with a rate of 47,000 per month in the previous three months.

While manufacturing employment continues to fall, other labour market indicators show some signs of improvement. In manufacturing, **total hours worked** have been stable since the middle of last year; **average hours worked** remained unchanged in October, after rising in the previous nine months; **short time working*** is now running at only one quarter of the January peak level; in the three months to October, total **overtime hours worked** were 11½ per cent up on the previous three months.

Unemployment continues to rise, although at a much slower rate; the average monthly rise in the second half of this year was little over half that in the first half of the year. Adult unemployment stood at just over 2¾ million in December.

The level of **vacancies** has been improving since the middle of last year, albeit from a very low level.

Balance of payments

Three months' figures — September, October and November — are now available. They remain extremely difficult to interpret, given the absence of complete data since February, normal monthly variability, and changed documentation procedures for exports in October.

The **current account surplus**, after rising sharply in October, fell to £193 million in November. The average monthly current account surplus between September and November was about £280 million, substantially below the levels recorded at the turn of the year.

Non-oil **export** and **import** volumes (excluding erratic items such as ships, aircraft, precious stones and North Sea installations) are shown in table 4.

Non-oil export volumes were, in the three months to November, considerably higher than the depressed levels at the start of 1981, and some 3 per cent higher than the level in the first half of 1980. The pick-up during 1981 appears to be fairly widely spread across all categories of goods and materials. This is despite the past loss of export competitiveness and the world recession.

There appears to have been a significant rise in the trend in non-oil import volumes, which were, in the three months to November, almost 8 per cent up on the first quarter of 1980. While this points to a further increase in the propensity to import over the past two years, it is consistent with the recent strengthening in manufacturing output and a reduction in the rate of destocking.

Table 4 **Export and import volumes excluding oil and erratic items**

1975=100, balance of payments basis, seasonally adjusted

	1H 1980†	Early 1981§	Sept-Nov	Increase in September — November over 1H 1980	Increase in September — November over Early 1981
Exports	122.2	113.2	125.6	2¾	11
Imports	140.9	120.7	152.1	8	26

§Exports refer to Jan and Feb; imports refer to Jan to April.
†Representative of the levels before the decline in the second half of 1980.

Economic Progress Report index for 1981

Page references are shown in brackets; (S) refers to Supplements published with Economic Progress Report in the months indicated.

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SP

MR PATTISON

BRIEFING FOR THE PRIME MINISTER - QUESTION TIME 28 JANUARY

OUTPUT AND PRODUCTIVITY

I attach a table at Annex 1, as requested, showing for 1979Q2 and 1981Q3, indices of:-

i) Output

ii) Output per person

iii) Output per person hour

for each of

a) Whole economy /(i) and (ii) only/

and b) Manufacturing industries.

The choice of 1979Q2 as a base is perhaps unfortunate as output in that quarter was atypically high and may distort comparisons.

At Annex 2 I have made some comments and comparisons on 1981Q3 with the average for 1979. The underlying figures are shown in Annex 3.

A separate note on unit costs in manufacturing is attached.

W ELMORE

Stats C3
Department of Employment

28 January 1982

ANNEX 1

	WHOLE ECONOMY			MANUFACTURING INDUSTRIES		
	Output	Output per Person	Output per Person Hour	Output	Output per Person	Output per Person Hour
1979Q2	112.1	111.7	na	107.4	112.4	111.2
1981Q3	104.5	112.0	na	90.4	113.3	115.1
Change 1979Q2 to 1981Q3 Percent	-6.8	+0.3	-	-15.8	+0.8	+3.5

All indices are based 1975 + 100 and are seasonally adjusted.

ANNEX 2

OUTPUT AND PRODUCTIVITY

Latest available information is for 1981Q3 and is summarised in the attached table.

For the WHOLE ECONOMY - Output (ie Gross Domestic Product) in 1981Q3 was 5.3 per cent less than the average for 1979 but OUTPUT PER PERSON EMPLOYED reached record levels in 1981Q3, being 1.9 per cent higher than the average for 1979.

There is no measure of output per person hour for the whole economy. The measure only exists for manufacturing industries.

For MANUFACTURING INDUSTRIES - Output in 1981Q3 was nearly 3 per cent higher than in 1981Q1 (when at its lowest level in the current recession) but was 13.6 per cent below the average for 1979.

OUTPUT PER PERSON EMPLOYED reached record levels in 1981Q3, being 3.2 per cent higher than the average for 1979 and 7.5 per cent higher than in 1981Q1.

OUTPUT PER PERSON HOUR reached record levels in 1981Q3, being 5.7 per cent higher than the average for 1979 and 7.2 per cent higher than the same period 1 year previously.

Productivity

ANNEX 3

Index : 1975 = 100

	WHOLE ECONOMY			MANUFACTURING INDUSTRY		
	Output	Output per Person	Output per Person hour	Output	Output per Person	Output per Person hour
1978	108.0	108.1	na	104.4	108.1	107.1
1979	110.3	109.9	na	104.6	109.8	108.9
1980	107.2	109.0	na	95.0	105.8	107.3
1981Q1	104.2	109.6	na	87.8	105.4	109.5
Q2	103.8	110.6	na	88.2	108.5	111.4
Q3	104.5	112.0	na	90.4	113.3	115.1

na - not available

All indices are seasonally adjusted.

BRIEFING FOR THE PRIME MINISTER - QUESTION TIME 28 JANUARY

1 UNIT WAGE COSTS IN MANUFACTURING INDUSTRY

May 79	-	148.7	(12.5% over previous 12 months).
Oct 81	-	203.8	(2.0% over previous 12 months).

2 RETAIL PRICE INDEX

In May 1979 the year on year increase in the Retail Price Index was 10.3 per cent. The latest figure available, for December 1981, was 12.0 per cent. The lowest figure since May 1979 was 10.9 per cent (in July 1981).

CF pp's pl.
MCS 20/1

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

19 January 1982

W F S Rickett Esq.
Private Secretary
10 Downing Street
LONDON
SW1

Dear Willie,

FEBRUARY NEDC: PRIME MINISTER'S BRIEFING MEETING

I note that in your letter of 21 December to Jonathan Hudson you say that the Prime Minister will be having a briefing meeting on 2 February in preparation for the NEDC meeting the day after.

We have not yet had the details of the meeting, and I assume that you have yet to arrange a time. As for attendance, you may wish to consider inviting not only the Chancellor but the Foreign Secretary, and the Secretary of State for Industry, since they too have a direct interest in some of the subjects to be discussed (inward and outward investment, Cancun, small firms and Mr Baker's action programme for the electronics industry).

You also refer in your letter to the Prime Minister's wish to have a short tutorial ("with plenty of visual displays") on the electronics industry. I assume that you do not intend to combine this with the NEDC briefing meeting, but will arrange it for an earlier date.

Yours ever,

J Jenkins

PP P.S. JENKINS
Private Secretary

Tr.
Ind.
~~F.~~ Tr.
Emp.
Energy

PERSONAL & CONFIDENTIAL

PRIME MINISTER

GETTING THE GOVERNMENT'S ECONOMIC MESSAGE ACROSS

You are to have a discussion tomorrow at 9.30 am with the Chancellor, Chief Secretary, Lord President and Paymaster General on the above subject. Michael Scholar and myself will be in attendance.

The notes below bring together comments upon the Chancellor's original minute of December 23 (Annex I); Sir Robert Armstrong's note of December 24 (Annex II); and my response to the Chancellor's minute. (Annex III).

First, the basic responsibility for the presentation of economic policy must rest with the Treasury. The in-house improvements recorded in Paras 2-4 of the Chancellor's minute are therefore to be welcomed, but I am bound to say that I regard the Treasury Information Division as one of the less effective and desperately in need of some dynamic professionalism. Too much emphasis is apparently put upon economic expertise and far too little on a robust ability - and enthusiasm - to communicate simply.

Second, the Government Information Service, under my leadership, meets regularly as a whole on Monday and in a more select group on Tuesday to co-ordinate, respectively the presentation of overall policy and economic policy. I report recommendations or decisions as necessary to the Lord President and your Private Office. A recent innovation is good news summaries (Annex IV) put out by D/Industry (and the Scottish, Welsh and Northern Ireland offices).

In addition the Lord President has established machinery for issuing Ministerial speaking notes on Government policy as a whole. He is however sceptical about their value, though there is some evidence they are appreciated, and the system has run down since Sir Angus Maude left. Mr Pym clearly signalled to Michael today that he intends to underline his scepticism tomorrow; doubts the value of the speaking note put out by the Chancellor on January 15 (Annex V); and believes we need a more positive and saleable policy.

Francis Pym had a talk with me. I suspect that his disenchantment is more with the policy than with its presentation. MCS 19/1

Third, the Chancellor (Para 5 of Annex I) makes an entirely valid point in calling for a wider Cabinet effort to put over Government economic policy. He suggests you urge non-economic Ministers in Cabinet to set their interests in the framework of wider economic policy. But this ducks the real issue - namely the propensity of Cabinet Ministers up to now to savage their own policies, if not often in speeches certainly in talking unattributably to the Press. All the slick presentation in the world counts for little or nothing if the Government is seen to be divided among itself or unhappy with its own policies.

Fourth. Sir Robert Armstrong has a point in emphasising the impact of broadcasting, and especially TV. He stresses the desirability of Ministers being more ready to argue the Government's case on current affairs programmes, and comment on economic events and to relate them to the Government's message day by day. I agree, provided of course we get a satisfactory format. There are great dangers in simply accepting each and every invitation regardless of other considerations.

But again Sir Robert Armstrong's comments evade the real issue: the failure of Government up to now to pull together.

Fifth. Sir Robert suggests the Secretaries of State of Employment and Energy and the Economic Secretary, Treasury, should be ready to respond to appear on radio or TV whenever invited. In my experience, we do not have problems in getting "loyalist" Ministers to appear; the problem is to get the Cabinet orchestra to sing in tune. But we really need non-economic Ministers to underline not merely the united nature of the Government but also its essential humanity. As, we hope, the economy improves and the improvement tells its own story we need also to convince people of the Government's "compassion", for want of a better word.

Sixth, links between Government and party (essentially Paras 8 & 9 of Annex I). This is now a basic problem because the departure of Sir Angus removed a bridge. But the problem is compounded by the fact that the Lord President, as the Minister responsible for co-ordinating the presentation of policy, is as uninterested in co-ordination or presentation as he is disenchanted with Government economic policy.

Para 9 of Annex I puts the finger on this aspect of the problem, without suggesting a solution. Given the representation at tomorrow's meeting, you will not wish to take decisions on this. But I do not think we can go on like this for much longer. The difficulties are:

- lack of Ministerial drive;
- lack of a bridge with defined responsibility for presentational liaison, between Government and party;
- the arguments against solving the problem simply by transferring responsibility from the Lord President to the Paymaster General as chairman of the party (which in other circumstances would be the ideal solution);

You will not wish to come to a conclusion immediately but the possibilities are:

- appointment of an additional Parliamentary Private Secretary to yourself with specific responsibility for presentational liaison with the Chairman of the Party in co-operation with me; Clive does not encourage this idea;
- appointment of a Junior Minister with a similar specific responsibility located either in No. 10 or Cabinet Office and with whom I would work closely; in the past junior Ministers have not been notably effective, especially when located outside No. 10;
- your devolving specific responsibility for co-ordination on me, charged as an official for reporting jointly to you and the Chairman of the Party as a member of the Cabinet; here the problem is to persuade people that you are not effectively putting the Chairman of the Party in charge of co-ordinating presentation;
- leave things as they are for the time being, with myself effectively co-ordinating but quietly liaising closely with the Party and at the same time reporting to the Lord President. This may well in practice happen because I am forging a good working relationship with David Boddy, as one half of the CCO operation, and Cecil Parkinson is anxious to have an early meeting with me.

19/1/82 B. INGHAM

Econ Pol Strategy

MAP

file no TEB/CA/01

PPS/CHANCELLOR

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(L)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for the Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 21 December, are sidelined.

M M Deyes

M M DEYES

R.A

R I G ALLEN

18 January 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. Has Government downgraded £M3 and PSBR?

That is an extraordinary conclusion to draw from the Chancellor's statement on 2 December and from the evidence the Chancellor gave to TCSC Committee in December. Consistent emphasis on need to keep steady but not excessive downward pressure on monetary variables and to restrain government borrowing.

4. Restatement of Government strategy?

Budget is customarily the occasion for a full statement of economic policy. I am sure my rhF Chancellor intends no departure from this tradition.

5. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of 1982 Budget.

6. Date of 1982 Budget?

My rhF Leader of the House will announce date of Budget in near future.

7. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

8. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth of money GDP fallen sharply. Inflation rate halved. Some good features in monetary picture - outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

9. Why are high interest rates needed?

[UK has abandoned domestic control: rates now fixed in Wall Street - claim by D Blake in The Times 14 January]

Current level of interest rates has reflected both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1½ per cent since September.

10. Expectations for 1982 disappointing?

[See B2 for details of December Industry Act Forecast]

No. Clouds are clearly lifting. Further falls in inflation in prospect. A rise in output instead of a fall. Good export prospects and current balance will remain in surplus. Admittedly a gradual undramatic recovery, but UK operating in difficult economic environment. Appreciable progress made on improving competitiveness and productivity. Important to build on this.

11. Unemployment in 1982?

Prospects for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects: IAF broadly consistent with assumptions in Government Actuary Report that unemployment in 1982-83 will, on average, be 300,000 higher than in 1981-82. But if things go well - pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.]

12. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

13. Tax increases necessary?

Cannot foreshadow Budget. Undoubtedly, higher public spending makes prospects for PSBR, interest rates and burden of taxation next year more difficult. But, as rhF said in

2 December statement, on conventional assumptions figures point to a PSBR next year broadly in line with projections published at time of Budget. Final assessment must await Budget next year. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

14. Government should change course?

(a) Moderate reflation the answer?

Government recognise need to respond flexibility to economic situation, within framework of overall strategy. But no question of abandoning that strategy. Cannot throw away gains made so far by return to discredited policies. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing resurgence of inflation and undermining financial markets, and, as a consequence, interest rates rising further and faster. Even large reflationary packages yield relatively small benefits eg NIESR £5 billion package would reduce unemployment by only 150-300,000 after 5 years.

(b) £9 billion package proposed by Mr David Steel?

[Liberals' paper 'A Chance to Work' released 7 January]

To a large extent a blown-up recapitulation of their earlier programme. Costing and job benefits optimistic (£9 billion expenditure; £3 billion PSBR; 1½ millionjobs in three years) - inflation implicatons hidden behind reliance on incomes policy. Result rosy against other reflationary packages (e.g NIESR see 14 (a) above).

(c) Reintroduce exchange controls and join EMS?

EMS is not a panacea. But Government does fully support EMS as an important step in monetary co-operation and closer integration in the European Community. Have stated that UK will participate in the EMS exchange rate mechanism when conditions appropriate both for the system and ourselves. Question is kept under constant review.

(d) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Latest information on output, production and stocks - recession over?

[NB: Index of industrial production (November) due out 18 January - separate briefing will be supplied.]

Fall in output now over. GDP output on latest - revised - figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2. Manufacturing output increased by 2 per cent in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking one-third that of H1 1981.// October* industrial production figures show continued improvement with manufacturing output up 2¾ per cent from low point (H1 1981). Autumn Industry Act forecast sees continuation of recovery in output.

2. Other evidence of improvement in economy?

[NB: Retail sales (December) figures due out 18 January. New cyclical indicators to be released 21 January.]

Engineering orders in 1981 show new orders total up 17 per cent on H2 1981; within this, export orders figure up 21 per cent. Retail sales figures for November* up 2 per cent on average for 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. November* cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

3. Government assessment of prospects

[New Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat.]

*Latest available at time of writing.

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

4. Investment prospects gloomy?

[Q3 1981 figures show little change for manufacturers and distributors' capital investment since Q1. December DOI investment intentions survey indicates 2 per cent rise for combined total manufacturers distributors and services (MDS) in 1982, bigger increase in 1983, but 1 per cent fall for manufacturers in 1982 (upturn in H2 1982).]

Welcome signs that decline in MDS investment is over, and DOI intentions survey points to prospect of rising investment over next two years.

[IF PRESSED on further decline in manufacturers' investment:

Survey points to pick-up in manufacturing during 1982.

IF PRESSED on consistency with Treasury forecasts. Early days yet; but latest information not inconsistent with IAF.]

5. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	1/3	1	
CBI (Nov)	0	2/3	
Phillips & Drew (Jan)	0	¾	
OECD (Dec)	-¾	-½	
(IAF - for comparison)	½	1	

November NIESR Review contains only annual data, but commentary suggests low point reached in H1 1981, with prospect of some recovery.]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic seeing recovery delayed to H1 1982 (OECD) and H3 1982 (ITEM). ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

6. Higher interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

7. Recession worse than in the 1930s?

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[December total count was 2,941,000 (12.2 per cent) - third consecutive month showing slight decrease. Seasonally adjusted excluding school leavers figure was 2,782,000 (11.5 per cent) Employment Secretary conceded in ITV interview 17 December that January unemployment total likely to top 3 million. (Figures to be published 26 January)]

Unemployment rising much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month in H2 1981 compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut -(down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised and now show signs of some pick up. Vacancies improving too.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 indications are that total employment declined at half the rate in H1 1981 (150,000 compared with 300,000 per quarter).]

Decline in manufacturing employment showing signs of further marked slackening in 3 months to October 1981 (28,000 compared with about 50,000 per month earlier in year), and 80,000 per month in H2 1980.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED on whether unemployment will "peak" in 1982. Mr Burns referred in evidence to TCSC (December 1981) to unemployment assumption given to Government Actuary; said it was not far from Treasury assessments. GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in wider range especially for beyond next year.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment; (figure of £450 million estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. Treasury's internal revision of figure published in February 1981 Economic Progress Report not published so far - further articles likely to be published in EPR and Employment Gazette in near future.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed. As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

7. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

8. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 has been increased by £160 million to over £520 million, with additional £61 million for the young worker scheme starting on 6 January 1982. The new Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £600 million

1981? in 1982-82 and £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be almost £800 million more than in last Public Spending White Paper (revalued).

9. Need to bring system of industrial training up to date?

Agreed. The White Paper 'New Training Initiative' sets out action required in industry and education as well as lead that Government are giving. New Youth Training Scheme will guarantee a full year's foundation training to those leaving school at the minimum age. Government objective is that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. An "Open Tech" programme is being developed to make technical training available to those with ability to benefit from it.

10. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government. Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

2. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in his statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. Other factors will also be important, including monetary targets and outlook for pay and inflation.

3. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

4. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be greatest help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

5. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year).

Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

6. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

7. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982)

8. The burden of corporation tax is too high/not high enough?

The Green Paper is not concerned with the burden of corporation tax but with its structure. It does show, however that burden of corporation tax has more or less matched changes in company profitability. The related question of appropriate burden of corporation tax is not covered in Green Paper but will be considered by my rhF in reaching his Budget decisions.

9. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

10. North Sea fiscal regime?

See R2.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

[Outturn for current year expected to be in region of £107 billion against £105 billion (revalued and adjusted) in last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring; changes in circumstances could well lead to higher or lower total than £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

5. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

8. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with this, but keen tendering will mean the programmes should be carried out as planned.

9. Number of cash limits breached last year?

[Full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as White Paper (Cmnd 8437) on 4 December.]

In aggregate, central government voted cash limits in 1980-81 were underspent by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the throughout public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

12. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is smallest for over 14 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 90,000 (over 4 per cent).

13. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

14. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

15. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

16. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

17. Increased burden on industry?

Very conscious of harmful effect of large rate increases. But remedy lies with local authorities. Realism of Government's plans means that there is no need for high rate increases.

18. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to bar supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

19. Financial help to authorities hit by recent extreme weather?

As already announced, Government is prepared to give special financial assistance to local authorities who would otherwise suffer an undue financial burden because of effects of recent severe weather.

IF PRESSED: As in the past, assistance being offered is 75 per cent of net additional expenditure which local authorities have incurred as direct result of emergency, above a threshold of a penny rate product. [NB - NOT FOR USE - this precise wording is important.]

20. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

21. No protection for industry?

An alternative to non-domestic rates involves much wider, more difficult questions. But interests of non-domestic ratepayers will be a most important consideration in developing a policy on domestic rates. Government's continuing pressure on local authorities to reduce expenditure (through Bill, block grant, cut in RSG percentage) will help all ratepayers.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast published 2 December shows PSBR in 1981-82 was £10.2 billion; PSBR in April - September was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CGBR April-December was £10¼ billion.]

Effect of dispute (concluded July) was to add around £3 billion to the CGBR, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

F SOCIAL SECURITY

1. Increase in employees' national insurance contributions?

[Chancellor and Social Services Secretary announced on 2 December 1 per cent increase in employees' national insurance contribution (from 7.75 to 8.75 per cent) from April 1982, as part of review of National Insurance Contributions. Increase will help to increase TPI from April - see J3. Social Security Bill to implement this had 2nd Reading 16 December].

An increase in contributions was necessary to pay for increased benefit expenditure (notably retirement pensions), increased redundancy payments and to maintain expenditure on the health service. Relative share of these costs met by employers has increased in recent years; we consided it essential to avoid placing this additional burden on them. Employers will still be bearing a higher proportion of the burden than they did ten years ago.

2. What about Treasury Supplement?

[Bill provides for 1½ per cent reduction in Treasury Supplement - from 14.5 to 13 per cent].

Treasury Supplement represents only one part of cost of benefit expenditure met by the general taxpayer. If all such expenditure taken into account, general taxpayer will still be funding as high a proportion of benefit expenditure in 1982-83 as this year - and substantially more than a few years ago. Not, therefore, unreasonable for contributors, rather than general taxpayer, to meet these extra costs.

3. Burden on employers?

We have avoided making any increase in employers' rate of contributions. Some increase in cash burden is, however, inevitable simply because of higher earnings. In addition, upper earnings limit has been raised by £20 to £220 - which adds a relatively small additional cash burden. Cash payments expected to increase by around 7 per cent, that is, slightly less than our estimate of the movement between 1981-82 and 1982-83 in earnings (7.5 per cent) and substantially less than the movement in prices (10 per cent).

4. Balance on the Fund?

We are budgeting for a very small deficit (£9 million) this year. The accumulated balance in the National Insurance Fund is of order of £5 billion. This may seem large as a proportion of expenditure; it has, however, been falling, and now represents about 13 weeks benefit expenditure - as compared with 25 to 30 weeks ten years ago. A balance of some weeks expenditure is necessary to cope with emergencies such as flu epidemics and industrial disputes.

5. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

6. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

7. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 15 per cent in September but have since fallen to 14½ per cent. Market rates firmed a little in December and have remained firm so far in January, in particular reflecting increases in US market rates]

Of course we want to see lower rates. But must proceed cautiously if we are not to let up in the fight against inflation. Clearing banks have already reduced base rates by 1½ per cent from their peak.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

5. Will there be an overshoot of money supply?

[£M3 increased by 0.2 per cent in banking December. Recorded increase in first ten months of target period was 12.6 per cent. (These statistics relate to new monetary sector introduced at mid-November - following introduction of new monetary control arrangements in August -which is wider than old banking sector as it includes all recognised banks, licensed deposit takers, and trustee savings banks. Effect of change was a once-for-all increase in level of £M3 which is excluded from growth figures given above.) Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high,

6. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) December. In nine months ending December the effect of the strike was to add around £3 billion to the CGBR.

7. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

8. Plans for modifying MTFS?

We shall consider the MTFS published with last year's Budget - but have no plans to revise the broad objectives. Too early to comment precisely on what form this will take, or how next year's financial targets will be presented.

8. But increase in bank lending not inflationary: house prices stagnant, retail sales flat or falling?

Very hard to distinguish upward pressure on prices due to bank lending from downward pressure due to other factors, especially falling real personal disposable incomes. Effect of higher bank lending will not be felt on prices immediately, but only with a lag. Could be some leakage from mortgage lending into general consumption.

10. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in December.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in December at 12 per cent, compared with lowest recent level of 10.9 per cent in July. Effect of increase in mortgage interest rates and of higher food prices estimated at about 0.2 per cent on December RPI. Industry Act forecast: 12 per cent by Q4 1981; 10 per cent Q4 1982.]

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See also P .]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be more; some less. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurance they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals considering offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. Offer to LA manuals higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[NUM have rejected revised offer worth 9.3 per cent on basic rates (Not to be quoted: 7.4 per cent on earnings); water manuals considering offer worth 9.1 per cent on rates, 8.8 per cent on earnings].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached. [IF PRESSED on prospects of miners' strike: I am confident that good sense will previal].

10. Private sector pay

[BL settled at 4½-5 per cent, National Engineering Agreement added only 5.1 per cent to basic rates; however Vauxhall manuals have settled at 7.9 per cent, Ford unions rejected 7.4 per cent. Cumulative average for private sector in round so far estimated at 7½ per cent by DE [NOT TO BE QUOTED], 8 per cent by CBI Databank survey].

There have been some welcome signs of lower wage settlements in the private sector so far in the pay round. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

*

[Increase in year on year growth from 9.3 per cent in September to 11.9 per cent in October may attract attention, though (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to October does not, however provide a useful indicator of recent trend in pay settlements.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Layard's wage inflation tax?

Like any other attempt to rely on incomes policy, Layard's proposal (picked up by SDP) would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

We are considering question of index-linking of public service and other public sector pensions, including the question of contributions made by public servants for their pensions. Changes in these arrangements could produce further savings in due course.

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* Latest available figure : November index will be published on Wednesday 20 January ,

K BALANCE OF PAYMENTS

1. Balance of payments in third quarter 1981

[Figures for invisibles and capital transactions published 9 December]

The capital account outflow in Q3 was much smaller than earlier in the year. Portfolio investment abroad (estimated at £1.3 billion in Q1) was only £0.6 billion in Q3. Total surplus on invisibles was £303 million.

2. What is happening to the trade account?

[November trade figures published 23 December]

November figures show that the current account continues in surplus.

3. Trends in exports

Exports are well up on a year ago: non-oil export volumes in three months to November were up 4 per cent on 1980. An increasing proportion of exports (now 24 per cent) go to developing countries.

4. Trends in imports

Across the board increase during last three months confirms recent evidence of slowdown in destocking, and recovery in output.

5. Trends in invisibles

Invisibles in Q4 1981 is projected at £167 million-much the same as in Q3.

6. Capital flows

The net capital outflow in 1981 Q3 was about £0.7 billion compared with £1.9 billion in 1981 Q2. These capital flows represent overseas investment which will provide a valuable source of overseas income in future years. There is no evidence that outflows deprive UK firms of capital to invest.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since last summer sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark, due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 15 January were $1.8745; DM4.31 and an effective rate of 90.60. Reserves at end December stood at $23.3 billion, compared with $23.4 billion at end November]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M8]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. We aimed to reduce official external debt to $14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only $13.3 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

Community Foreign Ministers met informally in Brussels on 14-15 January. The meeting did not solve all the outstanding problems, particularly in relation to the milk regime and the budget. But some progress was made. Foreign Ministers will consider matters further at their meeting on 25 January.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We are examining the new Commission estimates. If our adjusted net contribution in respect of 1980 and 1981 turns out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. <u>What is the current attitude of the UK Government?</u>

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

1. January NEDC meeting: Why did Chancellor refuse to analyse Mr Len Murray's reflationary package?

My rhf did not refuse to analyse on the Treasury forecasting model the effects of a suggested reflationary package of a £2 billion increase in public investment and a 2½ per cent cut in VAT. He is quite prepared to consider the effects of these and other policy options. But this work cannot be completed in time for February NEDC. In any case, a full agenda for the February Council has already been agreed with TUC and CBI.

2. January NEDC meeting: What was achieved?

There was a valuable discussion at the January Council, particularly on relationship between real wages and unemployment, both in the economy as a whole, and in respect of particular groups of workers, such as young, unskilled and in regions. The papers circulated by my rhf Chancellor stressed that the best hope for economic recovery lies in reducing wage and price increases further, and in sustaining recent rapid increase in industrial productivity.

3. Recent increases in interest rates - damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

4. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output rising in Q3 1981. Autumn Industry Forecast sees continuation of recovery in output.

5. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

6. Industry claims that 2 December package adds £600 million to employers' costs?

[Higher NIC £200 million; higher rates £400 million.]

In real terms burden of NIC/NIS on employer's likely to fall in 1982-83, for second year in succession. And company sector now in rather stronger financial position than a year ago, partly through Government policies to switch fiscal burden.

SMALL FIRMS

7. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

8. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued more than 1800 guarantees - well over half to new businesses. Total lending under scheme is already over £63 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

9. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

10. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Why not give British Telecom more?

The £340 million EFL is still relatively large, particularly for a profitable industry. Ministers will be looking to British Telecom, as to others, to make a substantial contribution through reduced costs. There could be a higher figure if the bond proves feasible.

5. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

6. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this year.

7. Future years?

Investment approvals for the years 1982-83, 1983-84 and 1984-85 have yet to be settled. They will be communicated to the industries in due course and will be published in the forthcoming Public Expenditure White Paper.

8. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries should be able, in total, to maintain broadly the same level of investment in 1982-83 as planned in the last White Paper, despite lower revenue, with higher investment in important industrial priorities, eg telecommunications. This will enable the 15 per cent real increase over the 1980-81 level, which was included in the 1981-82 plans to be sustained. These plans, in turn, represented the highest real level of investment in the industries since 1975-76.

9. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

10. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

11. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

12. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £350 million this year.

13. Nationalised industries not reducing high cost of overmanning?

6.6 per cent of working population are employed in nationalised industries. Nationalised industry manpower reductions since we came into office will reach 200,000 in 1982.

NATIONALISED INDUSTRY PAY AND PRICES

14. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. Alternative would have been an increased burden on taxpayer and distortion of market forces. But rate of nationalised industry price increases is now coming more closely into line with RPI.

15. Will HMG take action over electricity price rises to large users?

The CEGB's Bulk Supply Tariff Review has now been produced and is currently being considered by Ministers.

PRIVATISATION

16. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas Enterprise Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular in-house production. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute of Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

3. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

4. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

5. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

6. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The sale of 51 per cent of BNOC's upstream business next year means that an oil bond is no longer necessary.

7. Government "frittering away North Sea riches"?

[The Times 14 December].

No. Benefits of North Sea are being put to best advantage by reducing PSBR, interest rates, and non-oil taxes below what they would otherwise have been. Investment, both at home and overseas, is thus encouraged. Oil thus provides a valuable contribution to Government's economic objectives.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9½ per cent in November. Underlying rates falling in US and rising in Italy. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9½ per cent in November 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

5. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the

deferral of FF15 billion (£1½ billion) of capital investment. Recent Canadian Budget will reduce deficit.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

8. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

9. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to under 16 per cent from peak of 21½ per cent; also German rates declining.

10. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 18 January 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The Industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to November 1981 industrial output rose 1½ per cent while manufacturing output rose 1 per cent.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales in the 3 months to November 1981 were little changed. The volume of visible exports in the 3 months to November 1981 were 9 per cent above the average for January and February 1981. The volume of visible imports in the 3 months to November were 24 per cent higher than the average for January to April 1981. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,781,600 (11.5 per cent) at December count, up 17,300 on November. Vacancies rose slightly to 107,500 in December.

Wholesale input prices (fuel and materials) were unchanged in December; the year-on-year increase fell to 15½ per cent. Wholesale output prices rose ½ per cent and are 11¼ per cent above a year ago. Year-on-year RPI increase was 12.0 per cent in December. Year-on-year increase in average earnings was 11.9 per cent in October. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to December - £10.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 0.2 per cent in banking December.

Visible trade showed average monthly surplus of £135 million in the 3 months to November 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in first 11 months of 1981 estimated at £2.6 billion. Reserves at end-December $23.3 bn. At the close on 15 January the sterling exchange rate was $1.8685 and the effective rate was 90.6.

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

FST
EST
MST C
MST L
Sir D Wass
Sir A Rawlinson
Mr Ryrie
Mr Byatt
Mr Le Cheminant
Mr Middleton
Mr Ridley
Mr Burgner
Mr Cassell
Mr Dixon
Mr Kemp
Mr Mountfield
Mr Pearce
Mr R I G Allen
Mr Buckley
Mrs Gilmore
Mr Kelly
Mr Morgan
Mr Burr
Mr Quinlan

15 January 1982

The Rt. Hon. Francis Pym MC MP
Lord President of the Council

Dear Francis

PAY: PUTTING OVER THE MESSAGE

I mentioned in my minute of 7 January to the Prime Minister that I had asked my officials to prepare an up-to-date general brief for Ministers and Government supporters to use in putting over the Government's message on the need for moderation in pay bargaining. The Prime Minister has endorsed this initiative, and I now attach the material which has been prepared.

I hope that, as with similar material in the past, you would be ready to circulate this generally to our Ministerial colleagues, and also to make it available through appropriate channels to our supporters both inside and outside Parliament. The more widely these points are being made, the more chance there is that they will influence attitudes.

I am copying this letter and the attachment to the Prime Minister, Norman Tebbit, Cecil Parkinson, and Michael Jopling, and also to Sir Robert Armstrong.

GEOFFREY HOWE

Pay and growth

- Any Government must put some control on the amount of money in the ecconomy if inflation is to be restrained. The more money there is around, the less it comes to be worth, as with anything else.

- The growth in the amount of money has implications for the growth of national income - in money terms. But growth in output depends on how much of that growth in money national income is eaten up by rising costs and prices.

- Between 1970 and 1980 output (real GDP) increased by 16 per cent. But measured in purely money terms it increased by over 20 times as much - 335 per cent. Most of the increase in money national income was simply inflation.

- The Government's monetary framework is bringing down the growth of money GDP (to around 10 per cent a year over the last two years), and inflation has fallen rapidly. But what happens to output within that framework depends on decisions by both sides of industry, not least on realistic decisions about pay.

- The bigger the pay increase for each individual, the fewer the people that the economy can afford to employ. And the more money spent on pay, at the expense of already depressed profits, the less will be invested in new technology, new plant, and equipment so as to remain competitive and maintai jobs for the future.

Low pay increases are essential

- There has been a sharp deceleration in pay increases. Settlements averaged about 9 per cent in the year to last July, compared with about 18 per cent in the year before that.

- We are beginning to see the benefits. Unit labour costs increased by only 4 per cent over the year to September. Production increased in the third quarter of 1981 by nearly 1½ per cent in manufacturing, 1 per cent in industry generally, and over ½ per cent in the economy as a whole. Short-time working is down, overtime and vacancies are rising.

- Further moderation on pay is essential if these encouraging trends are to continue. Wages and salaries comprise 60 per cent of total industrial cost

- Much has been made of the balance between current and capital spending. The economy's major form of current spending is pay. If not restrained it will inevitably pre-empt resources for capital spending, whether in the public sector or in individual companies.

- International competitiveness remains seriously eroded. Despite a 10 per cent improvement since the beginning of 1981, it is still about 35 - 40 per cent worse than in 1975. Import penetration has increased from 22 per cent of home sales in 1975 to 26 per cent in mid-1980. For passenger cars it is over 50 per cent, compared with a mere 7½ per cent in 1970.

- Relaxation of the monetary framework provides no escape from the need to restrain pay: a revival of inflation would be just as harmful to recovery as excessive pay increases, as so much of British experience demonstrates.

What level of pay increases?

- There can be no norm: the point is that pay increases must take much greater account of market realities, which will vary from firm to firm. The only safe generalisation is: the lower the increase, the better for sales and job prospects.

- The Government has signalled its determination to achieve low settlements where it has or shares financial responsibility for pay. A factor of 4 per cent has been used in setting the provision from which the public service wage bill has to be met. The Government is holding to that provision (though within it some settlements may be less than 4 per cent and some may be more).

- It is not the case that a high 'going-rate' has already become established. There has been a range of settlements including several around 5 per cent (British Leyland 4½ - 5 per cent, National Engineering Agreement 5.1 per cent, clothing industry 5 per cent). Very few settlements in double figures, and every prospect of a marked reduction from the 9 per cent average level of settlements in the last pay round.

- Not true that industry has big profits available to finance pay increases. Profitability in UK manufacturing industry was one-third level in US, Germa and Canada during second half of 1970s. And real pre-tax rate of return in manufacturing fell from 13 per cent in 1960 to 2 per cent in 1980.

Living standards

- Rate of increase in prices (12 per cent over year to November 1981, forecast increase of 10 per cent over year to fourth quarter of 1982) does not provide any guideline for pay increases. The living standards of the community depend on the production by British workers of goods and services which people in Britain and abroad will buy. Without this, no amount of extra money will sustain those living standards.

- The period 1977-80 saw a $17\frac{1}{2}$ per cent growth in real take-home pay, at a time when output grew less than 3 per cent, and real disposable incomes of non-North Sea industrial and commercial companies fell by one-third. Inevitable that there should be a drop in living standards from this unsustainable level (which makes it easy to understand why unemployment has risen).

for
retention.

- Government wants improved living standards, but recognizes that these can only be generated by a sound economy. The real attack on living standards consists in pushing for big pay increases regardless of the adverse consequences for output and employment.

- High pay settlements are unlikely to give a lasting improvement even in the living standards of those who get them. They simply lead others to demand the same, and in the end no-one has gained.

- High pay settlements are however certain to mean a sharp drop in living standards for everyone whom they push into unemployment.

Unemployment and pay restraint

- The Government's emphasis on low pay settlements reflects its concern to create a prosperous economy with rising output and job opportunities.

- Those who demand high settlements show, whatever they may say, that they are not really interested in reducing unemployment. It is what they do which counts.

- Employers who concede big pay increases which they know will mean closures or redundancies are also creators of unemployment.

GOOD NEWS PRESS SUMMARY

COMPILED BY DEPARTMENT OF INDUSTRY FROM PRESS REPORTS

15 January 1982

SOUTH EAST

Over 500 new jobs are to be created over the next three years by Therm-a-Stor, double glazing manufacturers, which is to build a factory, warehouse and office complex in Peterborough, Cambridgeshire.

50 to 70 skilled workers are being recruited by McAlpine, Humberosk, Great Yarmouth, for existing and expected contracts in engineering work for the offshore energy industry.

20 extra staff are being taken on by Baron Meat Products Ltd of Wisbech

Up to 20 new jobs over the next year are expected to be created by Structure Flex Ltd, Melton Constable, which is hoping to move to a new site in Holt, Norfolk.

A £1 million order to supply 220 generating sets for the Middle East has been won by WEMS Manufacturing in Ipswich.

EAST MIDLANDS

100 new jobs are to be created by British American Tobacco when the first stage of a £22 million tobacco processing factory, which is to be built at Corby, becomes operational in 1983.

175 jobs will be created when Declon, the plastics firm, opens a £1.5 million factory at Corby.

A £20 million contract has been won by Ruston Gas Turbines for the Urengoy-Uzgorod gas pipeline, and the company has an additional order for 22 gas turbine generating sets worth £9.7 million for the same project.

WEST MIDLANDS

Orders worth £3.8 million are said to have been won by Thomas Walker and Son of Birmingham at the London Boat Show for its satellite navigation system.

£2 million is being invested in Aston Science Park by a joint company formed by Birmingham City Council and Lloyds Bank (each investing £1 million in the company). The company will set up and run the science park on a 3.5 acre site adjacent to the university, and will als provide advice and finance at favourable interest rates to help new companies and projects.

NORTH EAST

Over 180 new jobs are expected to be created by Lab Systems Ltd, Hartlepool, who are expanding their operation.

80 new jobs have been created as a result of a £1 million development by Stelmo Ltd, designers and fabricators of equipment for the engineering and construction industries, on the site of the steelworks at Consett.

50 new jobs are expected to be created by Ashdown Industrial Services Ltd, Hartlepool, manufacturers of degreasing agents, which is building a new plant in the enterprise zone. The plant should be operational in April.

15 more employees are being recruited by Silverseal Windows Ltd, Washington. A further 20 are expected to be created when a new factory opens in Stockton-on-Tees later this month.

NORTH WEST

70 new jobs are to be created over the next fifteen months by Asda. The chain, which operates over 80 outlets throughout the country is also planning to open 10 new superstores, each with a staff of about 300.

About 12 new jobs will be created initially upon the opening of a £1 million coach chassis assembly plant in Kirklees. It is to be operated by a new company to be set up by the Kirklees Metropolitan Development Company and Ward Brothers, coach operators of Lepton, near Huddersfield.

YORKSHIRE AND HUMBERSIDE

Between 50 and 100 new jobs are expected to be created by London and Manchester Securities which has invested in a new industrial project in Leeds, especially designed to help small firms and new companies. The development provides 20 units for a wide range of uses including workshops and storage.

WALES

About 500 new jobs will be created over the next three years following advance factory lettings to 16 companies in North and South Wales, according to the Welsh Development Agency.

OTHER ORDERS AND CONTRACTS

A £150 million contract for the construction of L-Sat-I, the first of a class of large satellites, which will be among the most powerful in the world, has been won by the Space and Communications Division of British Aerospace.

A £17.6 million order has been won by Thorn-EMI Electronics from a Middle East customer for Cymbeline mortar locating radars and spares.

About £2 million worth of orders, over half for exports, has been confirmed by Normalair-Garrett; part of the Westland Group.

File

BK

CCa
Pd

13 January 1982

January Economic Progress Report:
Article on the UK's External Assets and
Liabilities

Many thanks for your letter of 11 January which the Prime Minister has seen and noted.

MICHAEL SCHOLAR

Peter Jenkins, Esq.,
HM Treasury

RESTRICTED - COVERING SECRET

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Ecc Pol Strategy

Prime Minister

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MCS 12/1

AW

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

12 January 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

Clive Whitmore mentioned that the Prime Minister would like to see a note on the discussions at .... Chevening last week-end. The attached note, while not purporting to be a full record of meetings which lasted for more than 9 hours, does, I think cover all the main points discussed.

Yours ever,

John Kerr.

J.O. KERR

CHEVENING DISCUSSIONS - 9/10 JANUARY 1982

BRIEF SUMMARY OF MAIN POINTS EMERGING

Economic strategy

The objective of reducing inflation was crucial but not so far as to exclude consideration of its effects on output and unemployment.

2. A monetary framework should continue; this was desirable in itself as well as important for consistency of presentation. It should comprise elements which the Government could directly influence; target paths for inflation or money GDP were unconvincing. Primacy was likely to be given to £M3, but not exclusively to this. A mock-up should be produced of the MTFS showing how it might be presented at the time of the next Budget including in the first place quantifications of £M3, M1 and PSL2. Such a mock-up should extend over the period currently covered by public expenditure plans - that is, up to and including 1984-85 - though possibly with less precision in later years. The quantities assigned to the aggregates should be consistent with a steady downward pressure, starting from a recognition of the likely 1981-82 outturn for £M3. The mock-up should describe the evolutionary nature of the MTFS and monetary policy, and should put this in the context of wider budgetary objectives. Work might also be done on a composite indicator, but if adopted this would be for internal purposes only.

3. There should be no published target or band in respect of the exchange rate. However internal limits might be adopted which would become "triggers to thought" as the level, or rate of change, moved outside them. As between level and rate of change, it was thought that the absolute levels the more important, though precipitate change should be avoided. It was thought that the current level was about right, with a difference of view as to whether some small movement up or down was the more risky. There should be a leaning towards the present rate, and also a leaning towards stability.

4. So far as operational decisions on interest rates were concerned, substantive discussion of this paper was postponed.

5. On the level of the 1982-83 PSBR, different views were expressed as to whether something around the £7½ billion emerging from the updated interim forecast should be looked for, or something higher was acceptable. Discussion ranged over the desirability of looking for interest rates lower than they would otherwise be, meaning a low PSBR, and something giving more "tangible" benefits by way of actual tax reductions, which would require a higher figure. Come Budget time, the outlook for private bank lending then seen would have to be taken into account.

6. It was agreed that discussions of the level of 1982-83 PSBR should be conducted in terms of actual cash - that is, any 1981-82 tax backlog which as the result of the strike falls into 1982-83 should be regarded as revenue for that year for this purpose.

7. As between giving any tax relief available to companies or persons, it was argued on the one hand that prospects for the company sector favoured any assistance going largely to companies, whether by way of help with interest rates (cf low PSBR) or eg NIS reduction. On the other hand it was also argued that on the personal side it remained desirable to do something about the poverty/unemployment traps and that action here was important from a political point of view, having regard to how the personal tax burden had increased. There was also the question of helping with pay bargaining.

8. On indirect taxes, full revalorisation had to be seen as the maximum that could be looked for at the time of the next Budget. Indeed this might be optimistic.

9. In a tour de table seeking ideas about small douceurs in the next Budget, a number of suggestions, including the following, were made; reduction in corporation tax rates, help on interest rates for tax exhausted companies, limited measures in the social security field to help those on low incomes, development of help for small businesses, some reduction in NIS (if not a major cut), some reliefs on capital gains tax, and something, even if not very much, over and above full revalorisation on income tax thresholds.

10. The Chancellor asked in particular for further work to be done on :-

a. Limited and targeted help for the construction industry (DOE to be consulted) and

b. An inexpensive package which might help the disabled and similar and

c. A further trawl for measures to assist enterprise eg small businesses.

Public expenditure

11. The analysis in Sir Anthony Rawlinson's paper as to the necessary timing of public expenditure decisions was accepted.

12. Different views were expressed as to the desirability of bringing tax/fiscal stance decisions into line with public expenditure decisions. It was argued that the Treasury had the worst of all worlds at the moment; tax/fiscal stance decisions were coming increasingly into commission, while they were still not bringing effective leverage onto public expenditure decisions. This pointed in the direction of more detailed and quantified decisions being put in front of Cabinet colleagues on the tax/fiscal stance at the time public expenditure decisions were looked for, and, following this, some kind of early announcement; thus in effect a Budget, albeit with "Greenish edges" and capable of being modified later, before Christmas. The serious practical difficulties for Ministers and the Treasury about trying to frame a Budget in October-November, at the same time as the main public expenditure discussions, were recognised. It was also argued that there was a risk of the Treasury losing control of tax decisions, so that the PSBR - where the right level was in any case an elusive concept - became the residual with all the difficulty that implied for economic management.

13. The impending TCSC enquiry into the Armstrong Report was mentioned. The difficulties involved in presenting to the Committee some of the arguments which pointed away from the Armstrong concept was noted. The Chancellor said that it was most important that this enquiry did not give rise to a new "role of the C & AG" situation. A submission would go to the Chancellor within the next week.

14. It was agreed that the move to cash planning might have had the effect in practice of shortening the public expenditure planning period. But it was also agreed that neither the present period, nor of course cash planning itself, should be abandoned now. It was not thought there was much of a case for a full-blown cost terms 10 year planning apparatus alongside the shorter term cash planning apparatus, but more might be done by way of studying the possible evolution over the longer-term of the cost of major individual programmes.

15. The paper showing the evolution of public spending totals in the long-term was frightening. It illustrated the logical consequences of giving way to the inevitable pressures and appetites for more and better public services without having regard to the where-withal to pay for them. One factor this pointed towards was greater privatisation and/or greater payment by individuals for the public services which they consumed. But the difficulties were immense. As a first step it was necessary to persuade Cabinet, and then possibly the public, that the problem existed. It was agreed that a paper should be prepared, after discussion with Departments, with a view to bringing the matter before Cabinet after the Budget, possibly in May; meanwhile the Chancellor would say something at Cabinet at the end of January, or possibly circulate a short paper, giving notice of this. Therafter there might be a case for making public the picture, if only to try to avoid, or at least point out the dangers of, re-establishing the various pledges which currently plagued public expenditure constraint.

Some other points which were mentioned

16. There was no substantive discussion of the paper on the role of the Treasury in the field of Departmental financial management. But it was suggested that the question about merit rewards for individual managers should be kept under active review; and there was also agreement that it was necessary to seek to line up the management bookkeeping of departments with the Parliamentary needs and requirements for accounting etc. A political push might be needed in this whole area eventually.

17. Nor was there any discussion of the paper on local authority expenditure, though it was remarked that this was one of the most important, if not the most important, current problems in the public expenditure field, with its

interaction of constitutional and financial considerations. It was noted that a submission would be going forward to Treasury Ministers shortly.

18. The Chancellor asked that sight be not lost of the TASS and NICIT exercises. He noted with approval that the various "unconventional" ways of improving the labour market which had been developed in the Treasury in the summer were being pursued.

19. The overwhelming importance of better control and efficiency in the public sector as a whole was noted. It was observed that there was a limit to which the private sector alone could carry forward economic recovery, particularly if dragged down by an economically unhelpful public sector.

20. There was brief discussion of the first draft of a paper which the Chancellor might put to Cabinet for 28 January.

Central Unit
12 January 1982

E/Derek Howe

Prime Minister

(2)

You may wish to use the $13b figure at lunch tomorrow.

MCS 12/1

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

11 January 1982

Michael Scholar, Esq.,
Private Secretary,
10, Downing Street

Dear Michael,

JANUARY ECONOMIC PROGRESS REPORT: ARTICLE ON THE UK'S EXTERNAL ASSETS AND LIABILITIES

In view of the Prime Minister's recent public references to the Government's achievement in reducing official foreign currency debts, you might like to have an advance copy of the attached article. It will be published in the Treasury Progress Report on 13 January.

Table 3 brings the story on official debt up to date. At the time of the 1981 Budget, the former Financial Secretary predicted that by the end of 1981 the Government would have reduced official foreign currency debts to around $14 billion, from $22 billion on taking office. The table shows this has been more than achieved, with an end-1981 figure of $13.3 billion. The figures in table 3 need to be used with some care. $0.7 billion of the reduction in debts since May 1979 is due to a definitional change (Euro-sterling borrowing no longer counts as foreign currency borrowing); a further, smaller, part is due to a change in the valuation of non-dollar debt, with the recent strength of the dollar against other currencies; and over the same period the official reserves have been boosted by a $3 billion revaluation of our gold holdings. Nevertheless there is a fairly good story to tell in Table 3.

Tables 1 and 2 show the wider picture on the country's overall external balance sheet. Again there are statistical qualifications, and the figures need to be used with caution. But these tables too show the substantial improvement in our position since 1974-77.

Yours ever
Peter

P.S. JENKINS

Page 7.

Since exchange controls were abolished in 1979 it has been easier for the private sector to invest overseas and increase the UK's holdings of profitable overseas investment. These overseas assets will produce foreign currency earnings in future, which should continue to benefit the current account after the value of North Sea oil production has begun to decline.

There has, in addition, been a sizeable improvement in the net foreign currency position of the public sector. The reserves have been built up and the Government have made progress with the repayment of official external debt. Table 3 shows this more clearly. (Official reserves and official external debts only account for part of the public sector figures in tables 1 and 2.)

Table 3

Official reserves and foreign currency debt

$ billion (end-year)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Official foreign currency debt	5.2	7.8	12.3	14.0	19.3	24.5	23.4	20.9	17.5	13.3
Official reserves	5.6	6.5	6.8	5.4	4.1	20.6	15.7	22.5	27.5	23.3

Source: *Financial Statistics*, December 1981. See footnotes to tables 11.4 and supplementary table B, June 1981 issue.
Note: These amounts are valued on a different basis from those in tables 1 and 2.

le LP

UK overseas assets and liabilities

There has been a substantial improvement in the United Kingdom's net balance sheet over the past five years.

Current account surplus

Traditionally, the UK's overseas assets have exceeded liabilities abroad. By 1975 there was a position of near balance. The improvement since then in part reflects valuation changes: but in 1978 and especially in 1980 there was also a substantial surplus on current account. The proceeds of the surplus, which was helped by the growth of North Sea oil production, went to build up overseas assets or reduce overseas debt.

In the period 1978-80 there was a current account surplus of £3.2 billion, compared with a deficit of £5.8 billion between 1973 and 1975. Table 1 and the chart show the deterioration in the position up to 1975: and the improvement between the end of 1977 and the end of 1980. With a substantial current account surplus expected in 1981 there should have been a further improvement since the end of 1980.

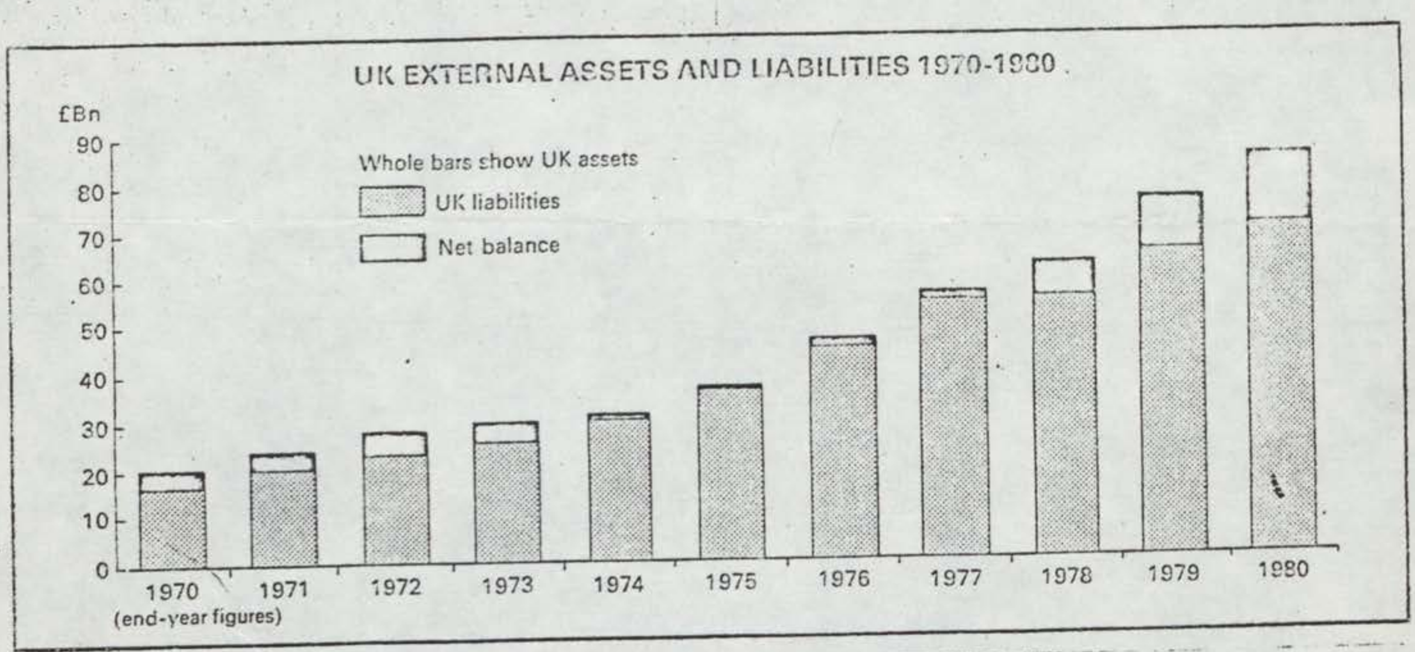

Table 1

UK external assets and liabilities

end-year figures
£ billion

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
External assets	20	24	28	30	31	37	46	56	62	73	85
External liabilities	17	20	22	25	30	36	44	54	54	62	70
Net balances	4	4	6	5	1	1	2	2	8	11	15

Notes:
1. Direct investment is at book values; portfolio investment at market values; property investment is excluded because of lack of figures.
2. For further notes see: *UK Balance of Payments 1981*, CSO, tables 11.1 and 11.2.
3. In tables 1 and 2 figures do not necessarily add, because of rounding.

There are difficulties in identifying and measuring outstanding stocks of both assets and liabilities, so that the net position is subject to particularly wide margins of error.

Public and private sectors

The figures show a net improvement since 1977 of around £13 billion. Table 2 shows that over a third of this was in the public sector's position, as official foreign currency reserves were built up and official overseas debts repaid. The rest reflects the balance between private investment overseas and overseas investment in the UK private sector. In contrast, figures for earlier years show that the UK's net holdings of overseas assets declined between 1972 and 1975 as the Government increased their overseas borrowing. The low value of sterling in 1976 increased the sterling value of both net private sector assets and net public sector liabilities denominated in foreign currencies.

Table 2

UK overseas assets (net of liabilities)

Balance, end-year
£ billion

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Private sector	-7	+4	+7	+6	+4	+5	+10	+4	+9	+8	+12
Public sector	[illegible]	0	-1	-1	-3	-4	-8	-2	0	-3	-3
Total	+4	+4	+6	+5	+1	+1	-2	+2	+8	+11	-15

PART 12 ends:-

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End of Year Briefing material

PART 13 begins:-

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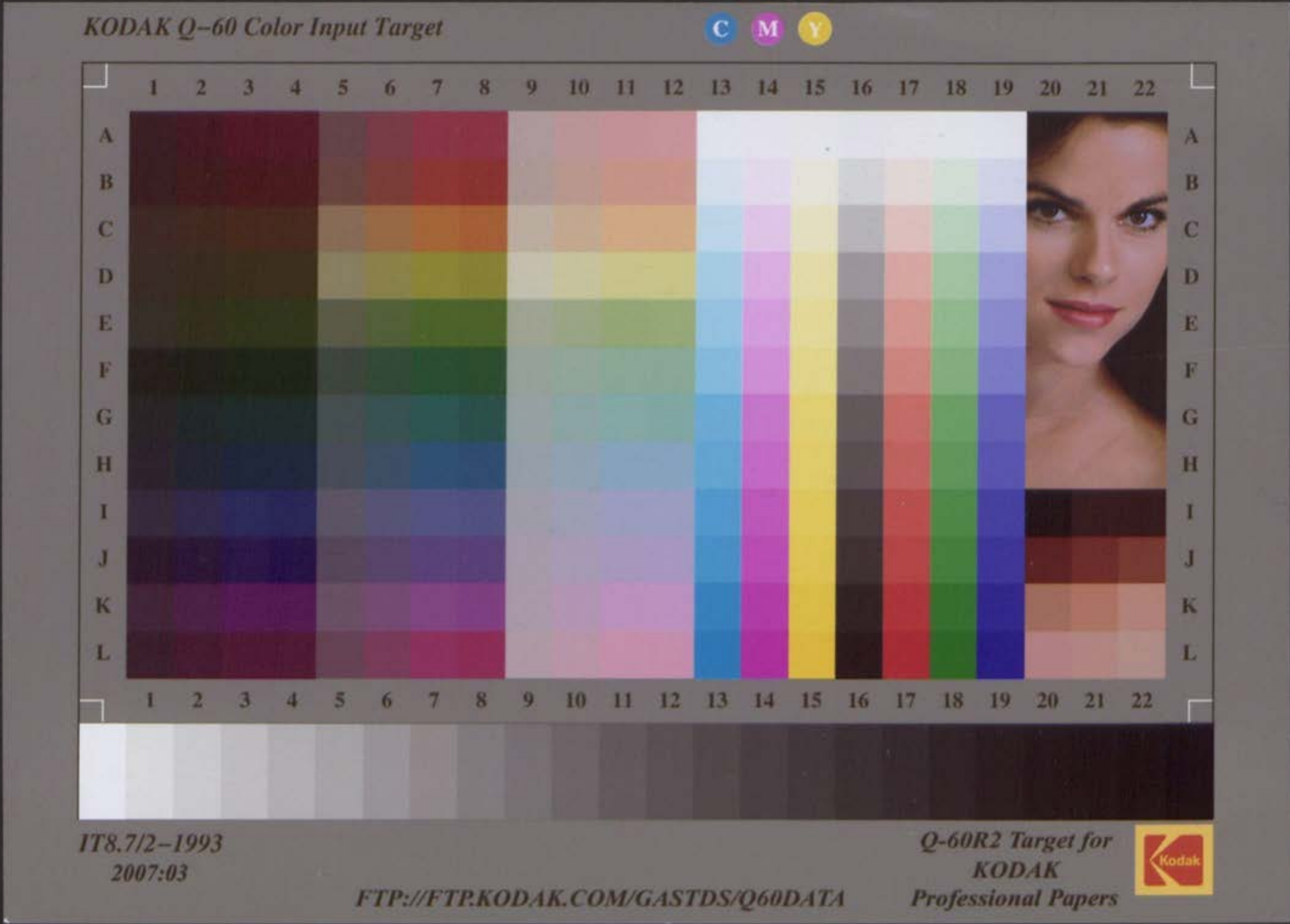
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