PREM 19/1705

Economic Strategy
Pay and Prices Monthly Economic Report
Economic Project.

ECONOMIC POLICY

Part 1 May 1979
Part 26 March 1984

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
7.3.84		23/7/85					
14.3.84		1.8.85					
27.3.84		20/8/85					
2.4.84		13.9.85.					
24.5.84		25.9.85					
24.6.84		26/9/85					
10.7.84		2.10.85					
26.7.84		14.10.85					
10.8.84		30.10.85					
30.12.84		5.11.85					
25.1.85		9.11.85					
7.2.85		Nov. 85					
13.2.85		29/11/85					
14/2/85.		18.12.85					
4.4.85		24.1.86.					
26/4/85		PART 26 ENDS					
16.5.85							
21.5.85							
30.5.85							
11.6.85							
18.6.85							
25.6.85							
2.7.85							
18.7.85							

PART 26 ends:-

DN NOTE FOR THE RECORD 16/12

PART 27 begins:-

REDWOOD TO PM 8/1/86

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(85) 13th meeting, item 4	18/04/1985
CC(85) 6th meeting, item 5	14/02/1985
C(85) 4	11/02/1985

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

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PREM Records Team

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NOTE FOR THE RECORD

DINNER WITH THE CHANCELLOR AND OTHERS
ON SUNDAY 15 DECEMBER 1985

The Prime Minister yesterday gave dinner to the Chancellor of the Exchequer, Chief Secretary, Sir Peter Middleton, and Sir Terence Burns. Nigel Wicks and Professor Brian Griffiths were also present.

The Prime Minister opened the discussion by expressing serious concern about the stance of policy at present. She believed it to be too loose, citing the growth of broad money, unit labour costs, house prices, retail sales and the behaviour of the stock market. There was evidence of excessive demand which risked higher inflation. The Treasury sought to reassure arguing that there had been a tightening of policy over last winter after a period during the Autumn of 1984 in which - with hindsight - policy had been a little loose. The indicators were not clear cut (see below) but on balance they supported the view that policy was not loose, and there was probably some effect of the tightening still to come. The Prime Minister appeared to take some reassurance from this, though she was ~~perhaps~~ not completely convinced.

Looking ahead, the Treasury pointed to the generally acceptable reception given to the Autumn Statement and argued that it was in any case premature to say that fiscal policy next year appeared to run risks of being on the loose side: no decision about the PSBR had yet been taken, and, when it was, the effect of the sizeable receipts from privatisation would need to be given proper weight - receipts from privatisation had in the past helped to hold borrowing below what it would otherwise have been. The Prime Minister concluded by emphasising the need for a prudent Budget, and indeed that there was a case for not making it too imaginative.

Generally, the theme of the evening was the Prime Minister urging prudence and caution. The Treasury whilst

agreeing, also pointed to the need for balance: UK industry was the only industry we had, and the pressures brought to bear on it had to take account of their ability to adapt, otherwise the result might be further increases in unemployment.

In greater detail, the main areas discussed were as follows:

- money and particularly £M3;
- labour costs;
- progress on inflation;
- stock market and mergers;
- consumer spending;
- house prices;
- interest rates.

Money

The Prime Minister was concerned about the high rate of growth of £M3 and its downgrading in the assessment of monetary conditions. After a period when its rate of growth seemed to be coming under control, it had now been rising for two years at an increasingly rapid rate. This could itself be seen as an indicator of loosening conditions and the build-up of liquidity could lead at some stage to excessive spending. It was important to have some measure of broad currency in the MTFS. The Treasury pointed to the slow growth of narrow money and argued that high real interest rates, falling inflation and increasing competition in the banking system were contributing to the rate of growth of £M3 and causing it to become a misleading indicator. They did not ignore it, or other indicators of broad money, though they themselves were mystified by the high level of bank lending. The changes to capital allowances were perhaps causing companies to borrow to finance higher investment in advance of the reductions in capital allowances. (The final stage would be reached next April.) Another possible explanation was that increasing use of financial swaps was leading banks to expand both sides of

their balance sheets. Nevertheless, the Treasury accepted that there was a build-up of potential spending power. What could trigger its use would be expectations of a rapid fall in the exchange rate and/or a rapid increase in house prices. These were threats to be watched, but on balance the Treasury did not feel that the behaviour of £M3 at present was a cause for major concern. Interest rates however had to remain high to keep downward pressure on inflation.

Labour Costs

The Prime Minister and the Treasury agreed readily that the rapid growth in unit labour costs was of course of concern. The broad stability of the exchange rate in the past few months (in effective terms) was increasingly coming into conflict with this growth, and employers needed to understand that depreciation of the exchange rate would not be accepted as a mechanism to bail them out. Rising costs, primarily reflected management. In this context it was noted that depreciation against the DM tended to help the competitiveness of exports, whilst appreciation against the Dollar tended to help import costs. But that was not a reason to look for continuing movement of the respective paraties in those directions. There had already been recently a substantial depreciation against the DM.

Inflation

The Prime Minister expressed concern about the slow progress being made on inflation, particularly against a background where inflation had fallen fast in other countries and had been as low as 3.7 per cent in the UK May 1983. The Treasury argued that the figure of 3.7 per cent had been to some extent artificial, since nationalised industry price increases that year had been low, and there had possibly also been some help from a lower mortgage rate. Most other countries excluded the mortgage rate from their price indices. If the mortgage rate was taken out of the RPI it seemed likely that underlying inflation would have been

running at 4.5 - 5 per cent for two years or more. Inflation next year should fall to 3.5 - 4 per cent by the summer, but again this was likely to be artificially helped by a lower mortgage rate. The underlying rate of inflation next year might still be more than 4 per cent. The Prime Minister urged the need to keep inflation from the middle of next year down to the "artificial" level it would reach in the middle of the year.

Stock Market

It was agreed that the present level of the Stock Market and the wave of take-over activity was "frothy".

The Chancellor pointed to the benefits which could sometimes be secured by take-over activity of the kind now going on, which led to de-mergers in some cases. The Treasury argued further that there was no real cause for concern: stock markets were high around the world and in real terms the UK Stock Market was not much higher than in 1973 even though corporate profits were much higher.

Consumer Spending

The Prime Minister pointed to the rebound of retail sales and to the expected rapid growth of consumer spending (4 per cent next year) as indicators of excessive demand. There was no substantive discussion of this point.

House Prices

Terry Burns argued that house prices were probably rising at about 8 - 9 per cent a year, on average, though there were wide regional variations. House prices tended to rise broadly in line with earnings. Their behaviour would become a case for concern if they were to rise much more rapidly than earnings.

Interest Rates

The Prime Minister pointed to the high level of real interest rates in the United Kingdom, and also to the way in which the markets had reacted quickly and adversely to the fall in oil prices as if they did not fully accept the rectitude of the Government's economic policies. The Treasury argued that market confidence had been substantially restored by, among other things, only two or three speeches from the Prime Minister and the Chancellor. This was encouraging. But in any case the United Kingdom did not have the long successful track record of Germany and Switzerland in running prudent economic policies. It therefore had to pay a premium in higher interest rates, and the Chancellor argued that this premium was linked in particular to the inducement needed to maintain the exchange rate at its present level.

The evening also included some discussion of mortgage interest relief, where the Prime Minister argued the need for an increase to help particularly younger people in London; and teachers' pay, where the Prime Minister showed some inclination to share the doubts expressed by the Chancellor and the Chief Secretary about the wisdom of an inquiry, though without committing herself: she continued to see some merit in an inquiry which focussed on teachers' contracts and conditions of service.

(Dictated from memory 16/1)

DN

DAVID NORGROVE

16 December 1985

Background (Terry Burns to introduce)

(a) World economy
  - US budget deficit and the dollar
  - oil prices
  - third world debt.

(b) Domestic economy
  - including pay and public sector unions next winter.

Objectives

Inflation: you have said 3% in 1988. Inflation was 3.7% in May 1983.

Why are costs rising so fast.

Monetary Policy

- Is policy consistent with the inflation objective?
- What is to be done about £M3 in the Budget?

Fiscal Policy

- Public expenditure control and prospects for 1986 Survey?
- Effect of oil price changes and higher privatisation receipts on desired PSBR?
- How will tax cuts (if any) be defended against unease that they are election give-away financed by selling off monopolies?

Mix of monetary and fiscal policy

- Why are interest rates so high?

Also:

Fraud and the City.

cc Mr Wicks
Professor Griffiths.

PRIME MINISTER

DINNER ON SUNDAY

You are giving dinner on Sunday to the Chancellor, the Chief Secretary, Peter Middleton and Terry Burns. Brian, Nigel and I will also be present.

The three of us will arrive at 6.30pm to allow half an hour or so to discuss the agenda. The others will arrive at 7pm. I suggest we start in the study and move into dinner at about 8pm. I attach a possible seating plan.

The dinner is intended to allow a debate about the economy and economic policy in which people can speak relatively freely. It should also help to ease tensions about discussion of economic policy which there may be after the ERM meetings.

For this reason, I suggest the following:

(i) you should start the evening by saying that nothing will be taken down and used in evidence;

(ii) I will not take a record;

(iii) we should not discuss either the ERM or figures for the size of the PSBR next year.

The Chancellor himself has not thought in detail about the fiscal stance and he would be very sensitive about detailed discussion. I suggest this aspect should be kept very general.

Brian Griffiths' note attached sets out an agenda. (I also attach a note by Alan Walters.) This falls essentially into three parts:

- the world and domestic economic background.
- objectives
- the policy stance: monetary and fiscal policy.

I have warned Terry Burns that you may ask him to introduce the discussion of the first part, and to give for 5-10 minutes a description of how he sees the economic position and prospects.

I am told that the Chief Secretary is not yet familiar with discussions of macro-economic policy and is likely to be out of his depth when a discussion gets among the Ms. But it will be right at some stage to invite him to talk about the position and prospects for public expenditure.

DRN

DAVID NORGROVE
13 December 1985

JA1AGA

13 December 1985

DINNER WITH THE CHANCELLOR

A. SCENE-SETTING

International Scene-Setting

Prospects

What are the prospects for world growth?

Risks

How risky is the international scene, given the uncertainties on:

International Debt?
The Oil Price?
The Dollar?

Domestic Scene-Setting

Performance. Where is the economy now?

Policy. What is the stance of fiscal policy and monetary policy at the present?

Prospects. What are the prospects for inflation, growth, and unemployment on current policies?

B. OUR GENERAL POLICY STANCE

Objectives

Is the overriding objective of policy to reduce inflation and keep it a at lower levels? (This does not mean you are insensitive to unemployment.)

The Mix of Monetary and Fiscal Policy

Why are interest rates so high? What should the mix of policy be?

Monetary Policy

Is present monetary policy consistent with our inflation objectives?

How should we express monetary policy (target ranges, aggregates, exchange rates, other factors)?

- Without moving to Monetary Base Control, should we increase the importance given to M_0? If so, how?

- Should a target range for £M_3 be given for the full 3 years of the MTFS as usual? Is £M_3 now so uncertain that we should only look one year ahead?

- Can we use a different target which is less distorted?

The PSBR

According to the last Budget, next year's PSBR should be £7½bn or 2% of GDP. The increase in forecast asset sales that year from £2.25bn to £4.75bn is an argument for reducing the PSBR. The fall in oil revenues - if we believe it to be temporary - is an argument for increasing it.

Tax Policy

How much money is there to spend on tax reductions? Should it go on thresholds or rates?

Will the Chancellor be publishing his Green Paper on fully transferable tax allowances along with the Budget?

Does the Chancellor have plans to change the tax treatment of pension funds in the light of their enormous surpluses?

Does he have any other groups in mind for special attention?

C. **WAGES**

Unit labour costs are holding up unemployment. Do we have any extra measures to influence them?

BG.

BRIAN GRIFFITHS

INFLATION

Increase in average Q4 RPI compared with average in Q4 of previous year.

Calendar Year	Change in Previous Year Q4
1980	15.3
1981	11.9
1982	6.2
1983	5.0
1984	4.8
1985	5.5
1986	3.7*

* Autumn Statement forecast

YEAR ON YEAR GROWTH OF GDP AT FACTOR COST

Calendar Year	Change on Previous Year
1980	-2.4
1981	-1.6
1982	+2.0
1983	+3.3
1984	+2.4
1985	+3.7*
1986	+2.9*

* Autumn Statement forecast

MONETARY GROWTH

Sterling M3

Financial Year	Target Range	Outturn
1979-80	7-11	16.2
1980-81	7-11	19.4
1981-82	6-10	12.8
1982-83	8-12	11.2
1983-84	7-11	9.7
1984-85	6-10	11.9
1985-86	5-9 (now suspended)	14.4*
1986-87	4-8	
1987-88	3-7	
1988-89	2-6	

M0

Financial Year	Target Range	Outturn
1984-85	4-8	5.7
1985-86	3-7	3.2*
1986-87	2-6	
1987-88	1-5	
1988-89	0-4	

* Last 12 months

SL2AEC

THE PSBR

Financial Year	PSBR	PSBR as % of GDP	Asset Sales	PSBR excl. Asset sales % of GDP
1971-72	1.0	1.6		
1975-76	10.3	9.3		
1979-80	10.0	4.8	0.4	5.3
1980-81	12.7	5.4	0.4	5.5
1981-82	8.6	3.3	0.5	3.3
1982-83	8.9	3.1	0.5	3.3
1983-84	9.7	3.2	1.1	3.6
1984-85	10.2	3.1	2.1	3.8
1985-86	8.0*	2.2*	2.5*	2.9
1986-87	7.7+	2.0+	4.75*	3.3
1987-88	7.0+	1.75+	4.75*	2.9
1988-89	7.5+	1.75+	4.75*	2.9

* Autumn Statement forecast

\+ 1985 Budget forecast

UNIT LABOUR COSTS

Calendar Year		Rise in Unit Labour Costs (Manufacturing)
1980		22.2
1981		9.3
1982		4.9
1983		1.3
1984		3.4
1985	Q1	5.4
	Q2	6.0
	Q3	6.9

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cc BG archive.

original filed on ECON POL: Domestic Monetary Policy: Pt 15.

December 6th 1985

Mr. Norgrove

Since I shall not be visiting London until mid January, I thought it might be useful to set out some thoughts on the present fiscal and monetary conditions.

Fiscal conditions are still perceived by the market to be still suspiciously loose - at least in terms of their expectations. Towards the end of last year the market rightly spotted the doubling of the rate of growth of public spending in real terms in 1984-85 (excluding special sales of assets), and although the Autumn Statement shows a slight decline in the level for 1985-86 and holding thereafter, we have had enough experience with over-runs, especially by the local authorities and demand driven programmes, to take such forecasts with a grain of salt. The political pressure for, and economic sense of, substantial tax cuts suggest that the public sector's financial deficit is unlikely to be further reduced even as a fraction of GDP.

Note: there is a very good case for judging our fiscal stance in terms of the financial deficit rather than the PSBR. The financial deficit does not count special disposals of assets as though it were a revenue receipt or expenditure reduction. It regards the disposal correctly as a transfer only.

Monetary conditions are clearly rather tight relative to the experience of the past four years or so, and relatively to what the market expects in the future. The evidence is, first the slow rate of growth - indeed

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over the past months the virtual stagnation - of Mo. Secondly there is a sharp downward slope in the yield curve. Short interest rates are about 11.5 per cent, whereas the yield on long term gilts is less than 10 per cent. This is the opposite of normal' conditions where the short term interest rate is usually about 1 or 2 per centage points less than the long rate. (In the United States shorts are about 7.5 whereas longs are 10.). This implies that people expect short interest rates on sterling financial assets to fall in the near future to levels well below the existing long rates, and a 'normal' sustainable pattern of long rates paying a reward of 1 or 2 per cent above short rates for the illiquidity of being in long assets. Thirdly, and much more dubious evidence, the exchange rate has remained relatively strong and still above all the purchasing power parity calculations of the pundits.

A Regan-Volker Policy ?

The combination of a tight monetary and loosish fiscal policy combined with substantial tax cuts looks superficially like the United States policy since the 1981 measures. But, apart from the sheer magnitudes involved, appearances are deceptive. The greater-than-normal upward slope of the US yield curve suggests that people expect that interest rates will remain high or increase (and the opposite is true in Britain). Such expectations are a consequence of views about the continuation of the deficit and about the likely monetary reaction to an outbreak of further inflation. Indeed we have no need to hit inflation hard with an associated appreciation of the currency by manipulating a tight monetary policy. Our inflation is already circa 5 per cent.

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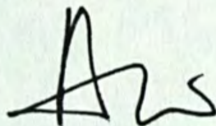
Stable Prices Ahead ?

If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability ! You may think, however, that it is best to approach such a nirvana rather more gradually and ease monetary policy in 1986 as suggested in our target for Mo. I would lean towards the latter policy and combine it with whatever can be done to tighten controls on public spending so that we avoid embarassments similar to those of December 84 to January 85. But I know that is easier said than done.



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CENTRE FOR ECONOMIC FORECASTING

FORECAST RELEASE

LBS Financial Outlook

EMBARGO : 00.30 HOURS MONDAY 25 NOVEMBER 1985

- New estimates prepared at LBS suggest that pension funds have £50bn of assets that are not needed to pay promised pensions. This figures uses very cautious assumptions, valuing the funds well below current market levels. The surplus has arisen both because of redundancies and because of sustained growth in foreign and domestic asset prices.

- We argue that the pension funds could eliminate these surpluses over five to ten years by reducing or suspending contributions, with benefit unchanged or improved. Lucas and Gomme (G-Plan) have done this. Corporate cash flow is improved and employment costs are lowered thus boosting jobs. And the Exchequer benefits because companies claim less tax relief - we estimate about £1$\frac{3}{4}$bn extra tax would be paid annually.

- The Chancellor can use existing legislation to make this happen, so his committment in the last Budget would be honoured.

- The pension funds and life companies have a cash flow of over £17bn a year. With their foreign investment now rather low, the UK private sector cannot provide enough assets for them to buy. The government has plugged the gap by selling too many gilts ('overfunding'), and now instead it is stepping up asset sales. Those asset sales cannot continue indefinitely, and we argue that reduced company pension contributions would plug the gap in a different and better way - by lowering pension fund cashflow.

EMBARGO: 00·30 HOURS MONDAY 25 NOVEMBER

Financial Outlook

Vol. 3 No. 1 November 1985

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Summary

What do pension fund surpluses, the ending of overfunding, and the increase in asset sales have in common? The answer is that all are elements in the government's revised scheme for using macro-economic policy to cycle unnecessarily large sums through the institutions. The Viewpoint (page 4) shows that even when a very cautious view about fund valuation and other factors is taken by pension scheme managers, they must now have some £50bn of spare assets which they do not need to finance promised pensions. The net inflows to the funds and life companies (table opposite, final row) are estimated at £17.2bn this year, rising to £17.9bn in 1986-7. The Viewpoint argues that these inflows could be cut by £5bn per annum with pensions unchanged. Some £1¾bn of this money would go to the Inland Revenue as less tax relief was claimed, and the rest would boost corporate cashflow.

We have argued in previous issues of *Financial · Outlook* that overfunding and the arge inflows to the institutions were opposite sides of the same picture. The government believed that excess gilts had to be sold to give the institutions assets they were prepared to buy at interest rates that the government regarded as acceptable. The announcement of the ending of overfunding in the Mansion House speech is in line with the view put forward in the first issue of *Financial Outlook* two years ago. Unfortunately the Autumn Statement has now revealed that the government plans a sharp increase in asset sales to around £4¾bn per annum. The bulk of these will be purchased by the pension funds and life companies, in part taking the place of lower gilts sales.

The replacement of overfunding by rapid asset sales means that the government is still dealing with the problem of the pension funds' cashflow in the wrong way. At first sight, the asset sales appear to fit in neatly to the flow of funds in the economy, providing the institutions with suitable assets in which to invest their enormous cashflow. This tidy picture assumes that the size of the inflows to pension funds is satisfactory, and beyond the control of government. As the Viewpoint shows, neither of these assumptions is true. By *supplying* artificially large quantities of assets, be they gilts or equities, the government is compounding a problem caused by an artificially high *demand* for assets. There is a danger of bringing to the equity market the crowding-out and distortions seen in the bond market over the last four years. The government should instead be using existing legislation to ensure that tax relief is given on pension contributions only if they are scaled down to the level needed to give the benefits promised.

The extent of the disequilibrium due to the pension fund and life company inflows is illustrated by our forecasts. These were prepared after the Mansion House speech but just before the Autumn Statement. As a result they show the ending of overfunding but asset sales, although raised from our previous forecast, are put at only £3.5bn in 1986-7 against the Chancellor's £4¾bn. Adding our figure for asset sales to the £6.9bn forecast for gilts sales to UK non-banks (table opposite, row 6, which also includes £2.3bn of other debt sales) and the £2.2bn for new issues by companies (row 2a; these fall next year from the current peak) gives a total supply of new debt of £12.6bn in 1986-7.

Against this supply must be set the pension funds and insurance company demands of £17.9bn. These institutions have now completed much of their post-exchange control diversification abroad, so their overseas assets purchases will be small next year. Allowing for some acquisitions of property and liquid assets, it is clear that their demand for UK debt exceeds the supply of new instruments. The situation will be resolved by the institutions bidding other sectors out of the market, notably the personal sector and the overseas sector.

The increase in asset sales announced in the Autumn Statement will help to fill the gap between demand and supply indicated by our forecasts, and reduce the prices which the institutions have to pay for their assets. However, this seems an inappropriate policy when the problem lies on the demand side. Far better to use existing legislation to persuade pension schemes to reduce their inflows, thus boosting tax revenue by some £1¾bn, cutting labour costs and leaving pension benefits unchanged or improved.

G.B.K.

Summary NAFA and financial flows

£ billion

	Public sector	Banks	Personal sector	ICCs	OFIs	Overseas
			1985/86			
1. Financial Balance	-10.5	2.4	13.6	6.4	0.1	7.3
2. Equity & deb. transactions (a) Issues	-2.5	-0.2	0.0	-4.6	-0.1	0.0
(b) Purchases	0.0	0.0	-2.2	2.4	6.9	0.3
3. Other contributions to PSBR & NDLs	-0.1	-2.0	-3.9	8.9	1.9	2.6
4. PSBR	8.0					
5. Banks' non-deposit liabilities		-4.6				
6. Debt sales to NBPS	-8.9		3.8	0.8	4.2	
7. Bank loans to NBPS		15.5	-8.8	-3.2	-3.6	
8. BoE Issue Department purchases of ICC bills	2.9			-2.9		
9. Foreign currency, & overseas sterling	-2.3	0.9	2.0	3.8	3.3	-7.8
10. Sterling M3		11.3				
11. NBPS bank deposits		-10.8	6.8	1.7	2.3	
12. NBPS notes & coin	-0.5		0.3	0.1	0.0	
13. Transactions between banks and public sector	1.0	-1.0				
14. Building Soc deposits & unit trust units			12.6	-0.8	-11.8	
15. Building Soc & OFI mortgages; hire purchase loans			-14.2	0.0	14.1	
16. Inflows to pension funds and life assurance companies			17.2		-17.2	
			1986/87			
1. Financial Balance	-11.6	2.6	11.3	7.7	0.3	-2.1
2. Equity & deb. transactions (a) Issues	-3.5	-0.2	0.0	-2.2	-0.1	0.0
(b) Purchases	0.0	0.0	-2.7	1.3	6.6	0.6
3. Other contributions to PSBR & NDLs	-0.6	-0.7	1.6	4.8	2.2	0.8
4. PSBR	7.5					
5. Banks' non-deposit liabilities		-3.6				
6. Debt sales to NBPS	-9.2		3.1	0.8	5.3	
7. Bank loans to NBPS		15.6	-8.5	-2.9	-4.2	
8. BoE Issue Department purchases of ICC bills	1.8			-1.8		
9. Foreign currency, & overseas sterling	-0.2	-0.7	0.2	3.0	1.4	-3.7
10. Sterling M3		11.2				
11. NBPS bank deposits		-10.6	2.5	5.1	3.0	
12. NBPS notes & coin	-0.7		0.7	0.2	0.0	
13. Transactions between banks and public sector	0.8	-0.8				
14. Building Soc deposits & unit trust units			11.4	-0.7	-10.7	
15. Building Soc & OFI mortgages; hire purchase loans			-14.7	0.0	14.7	
16. Inflows to pension funds and life assurance companies			17.9		-17.9	

Increase in assets or reduction in liabilities shown positive; reduction in assets or increase in liabilities shown negative

These tables are condensed versions of the full matrix of financial flows shown between pages 41 and 53. Corresponding full matrices of past data can be found in *Financial Statistics* and *Bank of England Quarterly Bulletin*.

Because of the National accounts residual error, the net acquisitions of financial assets do not always sum precisely to zero. The sum of unidentified financial transactions, included in the third row, is approximately equal and opposite to the residual error.

Viewpoint

The pension fund surpluses

GILES KEATING and MICHAEL SMYTH[1]

The Chancellor has promised to maintain the tax relief on pension funds for the time being but he has not agreed that the relief can be used for other purposes. Our estimates suggest that the funds have far more assets than they need to meet their obligations to pensioners. Even on very cautious assumptions the total of their surpluses stands at the staggering level of about £50bn, with the true figure possibly even higher. Our view is that the funds should be required to reduce these surpluses by suspending contributions and perhaps increasing benefits. This could raise tax revenues by about £1¾ per annum for ten years, while reducing industry's labour costs and leaving pension benefits unchanged or improved. It is possible that this can be achieved by the Inland Revenue without the need for new legislation.

Introduction

It is widely accepted that UK pension funds have far more assets than are needed to meet their projected liabilities, as a result of rises in asset markets and recent redundancies. No reliable estimates exist for the size of these surpluses, because of data problems and the wide range of possible assumptions. We tackle these problems partly by allowing the past behaviour of the fund managers to reveal their views, and partly by making explicit assumptions and showing the sensitivity of our results to alternative choices.

Our conclusions are staggering. On reasonable central estimates, the combined pension funds and life assurance companies have surpluses of almost £80bn, a third of which is due to redundancies, and the rest caused by rises in asset markets. Even on very cautious alternative assumptions, which value the funds well below their current market valuation, the figure is approximately £50bn. These enormous numbers must be viewed in the context of the funds' total assets which currently stand at over £250bn.[2]

The current over-valuation is more extreme than the under-valuation of the mid-1970s. Just as that shortfall was gradually eliminated by increased contributions (and by real cuts in benefits) so the current surpluses can be eliminated by reduced or suspended contributions, or higher benefits. Elimination of the surpluses over 10 years would save industry £5bn per annum in labour costs (if it was all used to cut contributions), helping to boost employment. This figure has a wide precautionary margin of £30bn, the difference between our best estimate for the true value of the surpluses and the more cautious estimate of £50bn used here.

The Inland Revenue would also benefit, by about £1¾bn a year, because the lower contibutions would imply less tax relief. If the surpluses were eliminated over a shorter period, then the immediate revenue gain would be even greater. Recent cases suggest that this revenue boost can be achieved by applying the existing rules and without violating the Chancellor's commitment to maintain the current reliefs – and with pension benefits unchanged or improved. We therefore recommend that the Inland Revenue should now require funds to report on the size of their surpluses and should insist that these be eliminated.

A stylised view of the funds

Pension schemes can be categorised in various ways, but the key distinctions with which we are concerned are between unfunded and funded schemes; and within the second of these, we are interested in the distinction between "final salary" schemes and "money purchase" schemes. In the UK the vast majority of schemes are the funded, final salary type. Such unfunded schemes as exist are mainly in the public sector and in 1983 these accounted for only about 13 per cent of benefits paid; in these, contributions are simply set each year at the level needed to pay the benefits previously promised.

The funded schemes have three essential components. These are the contributions paid in, the benefits paid out, and the stock of assets. In money purchase schemes, benefits are usually related to the value of the assets at the time each employee retires. By contrast in final salary schemes a level of benefits related to earnings is promised irrespective of fund performance. Most UK schemes are of this type, and so the rest of this section explains some important aspects of such funds.

When one of these schemes begins, it has no assets, but nor does it have any pensioners to pay.[3] The initial contributions into the fund are usually set at some percentage of the relevant wage and salary bill. If correct assumptions are made about rates of return, wage and price inflation, retirement and death rates etc, then this percentage is constant in all future years for some types of scheme, although it varies for others.

With no pensions to pay, the whole of the first year's contributions can be used to start building up the fund. From the second year onwards, some benefits will become payable, but they will be far

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[1] University of Ulster.

[2] This figure, like all those in this viewpoint, relates to the combined pension funds and life assurance company sector. The source is section 14 of CSO Financial Statistics. No breakdown between the pension funds and life assurance companies is available either for this figure or for benefit

[3] In practice, many schemes took over previous informal or

less than the contributions. In addition, the assets will start to provide some investment earnings. With income exceeding outgoings by a wide margin, the stock of assets will grow rapidly in these early years. Later on, the pensions in payment will rise. There will come an intermediate point at which the benefits equal the contributions, but the funds are still growing because of the investment earnings. The UK pension funds (plus life assurance) sector as a whole is now not far away from this point, with contributions (plus premiums) of £26bn and benefits of £18½bn in 1984. By comparison in 1973 the contributions (and premiums) were 1⅔ times as large as the benefits paid out.

Eventually, as more and more people with long contribution records retire, the benefits grow to exceed contributions, the investment income is used to pay for the difference, and the stock of assets stops growing. The fund is then said to be "mature".[4]

Unexpected events

This neat pattern is upset when one or more of the assumptions is not borne out by events. The most important errors that have affected UK pension funds in the last two decades have concerned the rates of return on assets; the general level of inflation; and the number of employees leaving service before retirement.

In the mid-1970s, errors in two of these areas combined to make the funds severely under-valued. Asset markets collapsed, implying a substantial negative nominal return on the funds; and inflation rose unexpectedly so the real return on the funds was a larger negative figure.

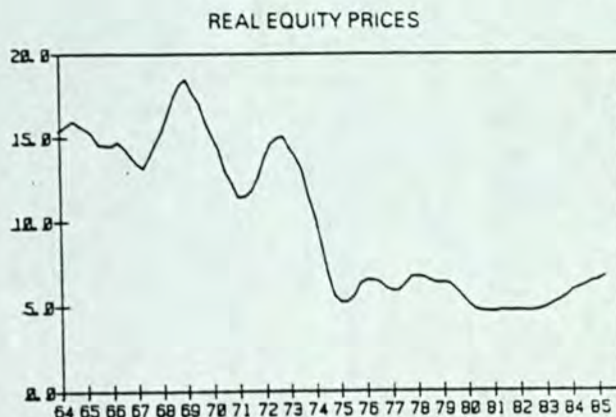
The collapse in stock market prices in 1974 can be regarded as a marking-down of the real value of the UK's physical capital stock because of the accompanying oil crisis. The real value of equity prices has not recovered, despite some small initial reversal of the worst of the fall (Chart 1). This indicates that the rise in energy costs and associated worldwide recession caused a permanent writing-off of many of the assets of companies. As major shareholders, the pension funds suffered a corresponding fall in their own assets. In addition, the increase in inflation raised interest rates and reduced gilts prices, giving a further capital loss to the funds.

This loss of assets meant that the evolution of the funds was interrupted. They were no longer on target for building up sufficient assets to meet their promises to pay pensions in future. To make good the shortfall, many companies provided "topping up" payments, over and above their normal contributions.

The effect of the stock market collapse was compounded by unexpectedly high inflation. Some of the funds' promises were fixed in nominal terms, including many frozen pensions due to early leavers. No provision for inflation was necessary in these areas,

Chart 1

REAL EQUITY PRICES



but many schemes decided to make ex-gratia increases for pensions already in payment. However, a large part of the pension funds' promises *were* linked to inflation. These were the pensions due to those still in service, which were related to final salary. To help pay for these, the parent companies had to make good not only the nominal fall in asset values but also the real decline due to unanticipated inflation. These topping-up payments were offset against corporation tax then at a standard rate of 52 percent.

Our estimates suggest that the stock market collapse and inflation of the mid-1970s caused the funds to be under-valued by some £16bn in 1974, which was the worst year, equivalent to approaching £40bn at today's prices. Even after the market had recovered somewhat in 1975, the figure was still £10½bn (£20bn at today's prices). This undervaluation was only gradually eliminated over the following years as companies topped-up the schemes (Chart 2). These calculations are based partly on examination of the schemes' behaviour, as revealed by the figures for the last twenty years, and partly using our own assumptions. The methods used and the sensitivity of the results to the assumptions are described in boxes 1 and 2.

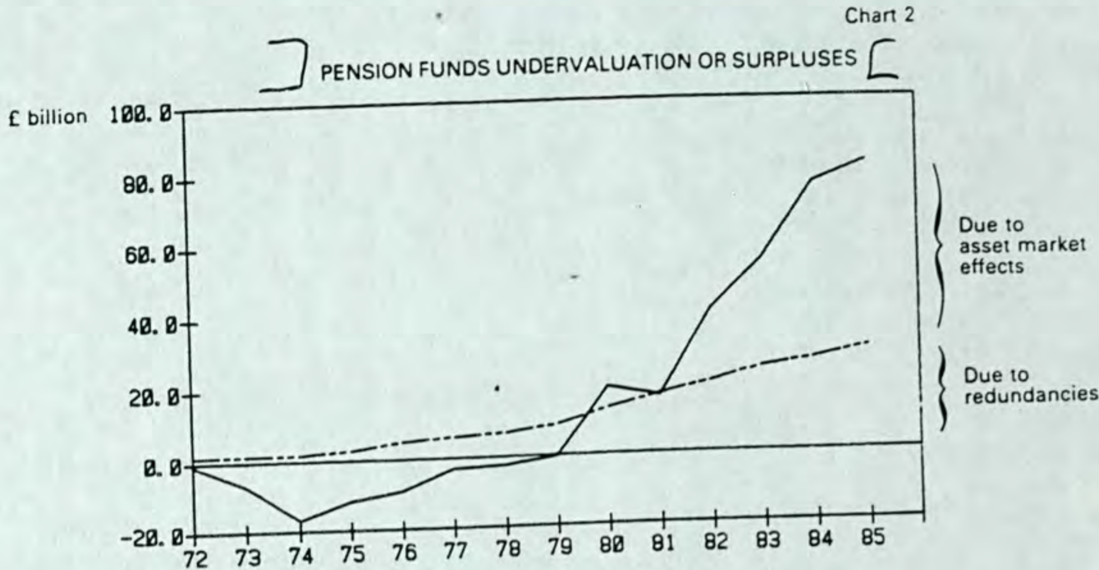
The 1980s

The pension funds and life assurance sector as a whole had returned to equilibrium at the end of the 1970s (Chart 2), but this has been followed by a sharp movement into surplus. The funds have made large-scale unanticipated gains on their asset portfolios, tending to raise their value to well above what is needed to pay for future pensions, with current contribution rates and other assumptions held constant. At the same time widespread redundancies, concentrated among male manual workers covered by pension schemes, have reduced the value of the pensions payable in future. We will examine these two factors in turn.

The capital losses in the mid-1970s were due to the collapse of UK asset markets. The gains of the 1980s have partly been due to the reverse movement as equity prices and to a lesser extent gilts prices have

Chart 2

PENSION FUNDS UNDERVALUATION OR SURPLUSES



the 1970s (Chart 1), and the picture is similar for gilts. A major additional source of capital gains has been the funds' overseas assets. This is partly because asset prices in the US and elsewhere have risen sharply over the last five years. It is also because the ending of exchange control in 1979 was followed by a period in which sterling was very strong. This allowed the funds to make their first major purchases of overseas assets at prices which, measured in sterling, were very low indeed. Since the start of 1981 the depreciation of sterling has given the funds an extra capital gain on their foreign holdings.

The pension funds have also benefitted from the very high rate of redundancies occurring particularly between 1980 and 1983. These redundancies occurred for well-known reasons, following the sharp loss of manufacturing industry competitiveness in 1980.

The redundancies contribute to pension fund surpluses because those who lose their jobs are generally treated as 'early leavers'. Had they stayed with the company to retirement age, their pensions would have been related to their final salaries. As early leavers, their pensions are instead usually frozen at a level linked to their salary in the year of redundancy. In some schemes there may be some increase allowed, but this often falls short of full inflation protection; it is usually far less than needed to allow for the real rise in earnings that would have been achieved if the employee had stayed with the company to retirement.[5]

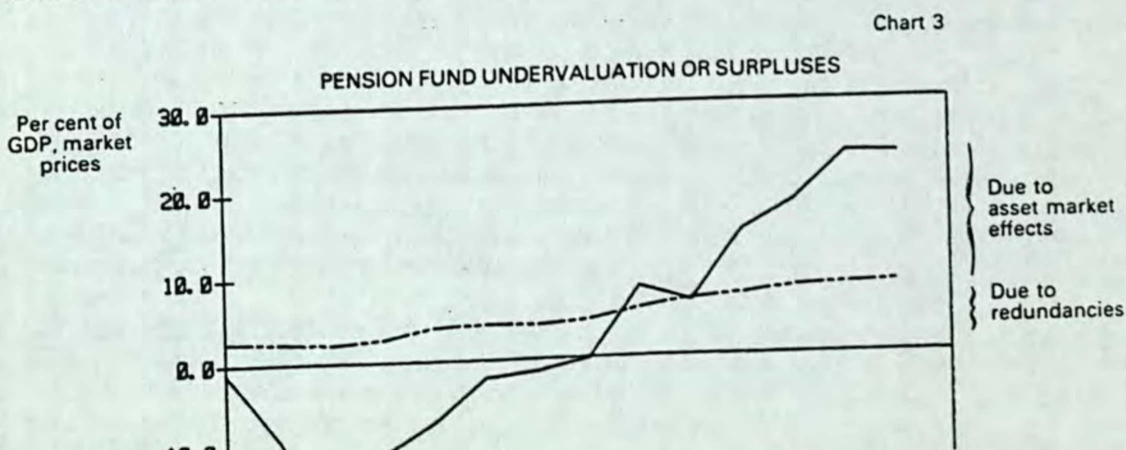
The value of the pension that will ultimately be paid to those made redundant will therefore be much less than if they had kept their jobs. There will be some corresponding reduction in the funds' receipts, because no further contributions are paid once the employee is made redundant. This loss of contribution income is considerably less than the cut in benefits and as a result the funds' surpluses are increased by the redundancies. Moreover, if the former employees (or others) find pensionable employment elsewhere then contributions into pension schemes as a whole will be little affected even though future benefits will be reduced.

On our central assumptions (discussed below), the combined effect of the funds' recent capital gains

(5) New legislation requires frozen pensions in future to be raised by 5 per cent or the rate of inflation, whichever is less, but makes no allowance for real increases.

Chart 3

PENSION FUND UNDERVALUATION OR SURPLUSES



Estimates of asset price effects

To compute the size of unexpected price movements in asset markets, we assume that the fund managers' central guess is that future gilts prices will remain unchanged and that UK equity prices and foreign asset prices will rise in line with the anticipated rate of UK inflation. Any difference between what would have happened according to these simple rules, and what actually occurred, is taken as our figure for an unexpected stock market movement.

Each of these simple rules is intended to reflect the idea that there are no opportunities for abnormal profits in asset markets. Thus for gilts, if the fund managers and others expected prices to rise in future, then usually they would all try to buy now. This would drive up the price straight away and restore our assumption which says that the best guess is for no change. In some special cases, such as low-coupon gilts near maturity, there may exceptionally be a general expectation of a price rise, but we ignore this complication.

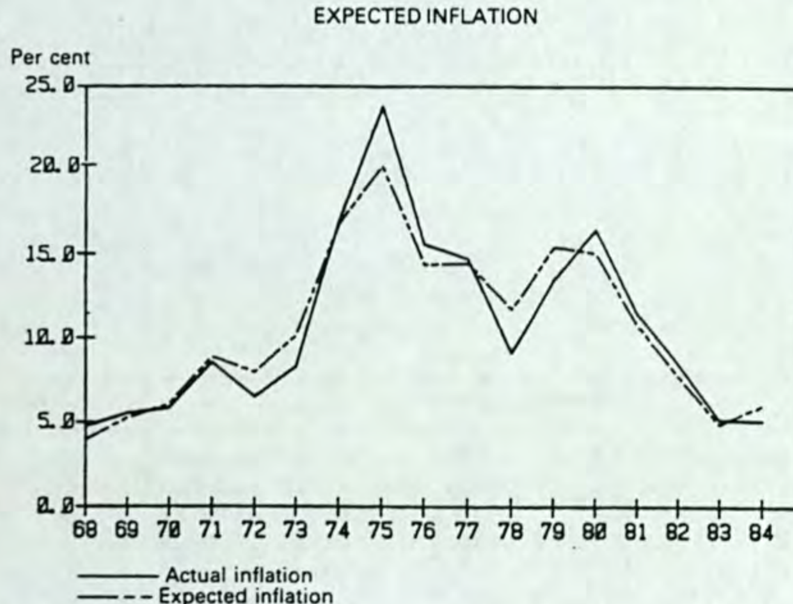
To explain our rule for equities, note that these assets represent a claim on the physical capital stock of companies. The value of this stock, after allowing for depreciation, will tend to rise in line with inflation (except when unanticipated external events such as oil price shocks occur). Equity prices must rise at approximately the same rate in the long run to ensure that companies' market valuation and their underlying assets do not move out of line. (This assumes net investment is financed by new issues.) Similarly for the sterling price of overseas assets, the exchange rate will adjust for inflation differentials between the UK and abroad.

Each of these rules is a crude representation of a complicated process of asset price determination. The LBS model, for example, allows far more variables to affect these prices, but in the long run it obeys these simple rules. However, it must be emphasised that the history of asset prices in the last twenty years has been dominated by a small number of large nominal price movements, such as the equity collapse in 1974 and (for overseas assets) the gyrations in the exchange rate from 1979 to 1983. The effects of these movements on our results are very large relative to any difference that would be made by choosing plausible alternatives to the simple rules described above.

We need a measure of inflation expectations to use in our simple rule for asset prices, and we obtain this by inverting the relationship which the Treasury and others have shown to exist between money supply (M0) and inflation. We argue that the quantity of M0 held is a good indicator of what everyone expects the general price level to be over the coming year. This approach suggests that people have anticipated many of the price movements over the last twenty years, with several noticeable exceptions (Chart 4). In particular they did not anticipate the rapid acceleration of inflation in 1974, nor did they expect the VAT rise in 1979.

Chart 4

EXPECTED INFLATION



Given these figures for unanticipated movements in asset prices and inflation, we can easily derive the size of the unexpected changes in the value of the pension funds. This is done by multiplying the unanticipated shifts in asset prices by the value of the funds' holdings of each asset, in each year.

The effect of these unexpected changes will persist and grow in line with the average return unless the pension schemes and their parent companies take action. We assume that they eliminate gradually the effect of the expectational errors. This may occur by adjustment of contributions or benefits, or both. We assume that this is done in such a way that the effect of the errors persists fully for six years and is then eliminated. With a 10 per cent nominal return this is approximately equivalent to taking no action initially, and then after 2½ years making topping-up payments each year for 5 years of about one-quarter of the original shortfall.

For our alternative estimates we use a more cautious assumption by valuing the funds as though over the six years they move halfway between the rate predicted by the simple rule and what actually happened. Each of the different assets in the funds' portfolio is treated separately, to allow for the two different simple rules. The effect of this is to reduce to £35bn the current contribution to the surplus from asset price effects.

and of the redundancies is to give surpluses of over £80bn. Of this, rather under half is due to the redundancies and the remainder to the unexpected rise in asset values (Charts 2 and 3, and tables 1 and 2). As for our estimates of the undervaluation in the 1970s, these figures are sensitive to the assumptions used and are subject to wide margins of error. Despite this they give some idea of the orders of magnitude. Our sensitivity analysis suggests that even on very cautious alternative assumptions, the funds have surpluses of about £50bn. We now turn to the calculations underlying these figures.

Estimating the surpluses

To calculate the size of the surpluses, we look at the effects of each of the three factors mentioned above: unexpected asset price changes; unanticipated inflation; and unplanned redundancies.

To calculate the effect of unanticipated asset prices and inflation we compute the value the funds would have taken if asset prices had followed two simple rules. For gilts the rule is 'no price change', for UK equities and foreign securities the rule is 'price rises in line with inflation'. The reasons for choosing these rules and our method for calculating inflation expectations are given in box 1.

Unanticipated changes are defined as the difference between what actually happened and the fund value predicted by these simple rules. The pension schemes react to unanticipated shocks in asset markets by altering contributions and benefits to adjust gradually the value of the fund, and so the effect of each shock persists but is eventually eliminated. The results of our calculations suggest that unexpected asset price changes are now contributing some £50bn to pension fund surpluses (Table 1, column 4).

Some fund managers take the view that their assets should not be valued at market prices but at some other price which represents their view of the level at which the market 'ought' to be. While we accept that some margin should be allowed for the risk of future price changes, we feel this approach is often taken too far. If fund managers really believe that the market is incorrectly valued they should sell, or sell short as appropriate. The only reason for not doing this is when the funds are large relative to the market.

Despite our doubts, we recognise that many managers use their own view about prices when valuing their funds. We have therefore prepared alternative estimates, based on a very cautious valuation policy. We value the funds as if only half of the unanticipated shocks have occurred. Even with this cautious assumption, we estimate that unanticipated asset price movements are contributing some £35bn to the fund surpluses in 1985. This compares to the figure of £50bn from this source obtained on our central assumptions.

Redundancies are the other cause of pension fund surpluses. They reduce future pension payments, and we estimate the size of this cut by using an econometric equation which allows for all the factors

Table 1
The sources of the surpluses
£ billion; positive numbers indicate surpluses, negative numbers show undervaluation

	Redundancy effect			Asset market effect	Total
	Benefits lost	Contributions not paid	Net present value of lost benefits, starting in ten years and lasting for fifteen, less net present value of ten years' reductions in contributions, discounted at 2½ per cent		
	In respect of the six years ending:				
1972	0.5	0.4	2.1	-2.3	-0.2
1973	0.5	0.4	2.2	-8.4	-6.2
1974	0.5	0.4	2.4	-18.6	-16.2
1975	0.9	0.7	3.8	-14.2	-10.6
1976	1.2	0.9	5.5	-14.0	-8.5
1977	1.2	0.9	6.0	-9.0	-3.0
1978	1.3	0.9	6.5	-9.1	-2.6
1979	1.5	1.0	8.0	-8.8	-0.8
1980	2.3	1.5	12.0	5.7	17.7
1981	2.7	1.8	14.8	-0.5	14.3
1982	3.1	2.0	17.2	20.4	37.6
1983	3.7	2.4	20.4	30.2	50.6
1984	4.1	2.6	22.4	49.5	71.9
1985	4.5	2.9	24.8	52.5	77.3

that determine the benefits paid by the funds. This equation indicates how pension schemes have in the past responded to changes in employment, and we assume that they react in the same way now. Against the reduction in benefits must be set the lower contributions. These are taken as proportionate to the fall in numbers employed, less an allowance for some of the former employees (or others) finding pensionable employment elsewhere.

The unexpected shifts in asset prices affect the *stock* of the funds' assets, but the reduction in benefits and contributions affects the future *flow* of the funds' transactions. They must therefore be capitalised using net present value methods. On our central assumptions, described in box 2, the capital value in 1985 of the effect of the redundancies is a reduction in fund liabilities of almost £25bn (Table 1, column 3). On alternative cautious assumptions, also set out in box 2, this figure is reduced to £15½bn.

Adding the redundancy effect to the asset price effect gives our central estimate of just under £80bn for the current level of the pension fund and life company surpluses (Table 1, column 5). The corresponding figure on cautious assumptions is £50bn. Although the details of the assumptions and calculations can be debated, it appears that extreme assumptions are required to derive figures that differ from ours by an order of magnitude.

What should be done to reduce these large surpluses?

Eliminating the surpluses

There are three main methods of reducing the surpluses in individual private sector pension funds.

1. A lump-sum clawback approach, which has just been achieved by Redfearn National Glass.
2. A suspension of contributions, recently proposed by Lucas Industries and Gomme Holdings. This is known as a *contributions holiday*.
3. An enhancement of both the rate of benefits and the lump-sum paid to members upon retirement.

In recent months there have been several examples of these methods. Lucas has announced a two year suspension of contributions which should increase its pre-tax profits by the amount of contributions deferred – in this case around £40 million in total. Similar decisions in other companies will inevitably follow and it could be argued that they lead to distortions of corporate market valuations.

A variation on the contributions holiday theme was adopted by BBA Products Group. BBA decided not to allow its holiday to boost profits in the way that Lucas has done – rather they opted for a reduction in its rate over a number of years. In this way there will be no significant fluctuations in profits due to the clawback. Two further applications for clawbacks have received different decisions from the Inland Revenue. Gomme Holdings, the furniture manufacturers, attempted a cash transfer from its pension scheme but was refused permission, presumably

Box 2

The effect of redundancies

Here, our approach is to estimate an econometric equation for the pension benefits paid out by the funds. This explains the benefits paid per member of the retired population as a percentage of GDP (with allowance for early retirement). Our equation allows for this to rise over time, rapidly over much of the last twenty years as the funds grow and less rapidly in the 1990s and early years of the next century, as the funds approach maturity. It also allows for real changes in benefits that occur as a reaction to unanticipated asset price movements. Finally, and relevant for determining the effect of redundancies, the equation also depends on the total level of employment. Full details will be available in an LBS working paper due out shortly. Note that official figures for redundancies are only available on a consistent basis back to 1977 and we have estimated figures for earlier years using a regression of redundancies on changes in manufacturing employment.

We multiply the number of redundancies by the coefficient on employment from our equation for benefits. This gives us an estimate for the reduction in future benefits due to redundancies in any one year. As for the effect from asset prices, we assume that this effect persists initially but is eventually eliminated by adjustment to benefit and contribution rates, and we model this by assuming that the effect continues for six years. We assume that the 'average' redundant employee retires after ten years and then receives pension payments for fifteen years. For our central estimates we compute the net present value of this effect by discounting at 2½ per cent. For our cautious estimates, we discount at 3 per cent.

Against this reduction in benefits must be set the loss of contributions from those made redundant. One extreme assumption would be that either they find pensionable employment fairly quickly or that others previously unemployed or out of the labour force take up such jobs. In this case the benefits are lost because of the early leaver effect but contributions are little affected. For our central estimates, we assume that one-quarter of the number losing their jobs are replaced in this way, and for our cautious estimates we assume no such replacement. We then calculate the decline in contributions as proportionate to the reduction in numbers employed. In line with the assumption about the typical redundant employee, we assume that contribution are lost for the next ten years. We compute the net present value of this, again at a 2½ per cent discount rate for our central estimates and a 3 per cent rate for our cautious estimates.

The net effect of the redundancies is thus the present value of reduced benefits, minus the present value of lower contributions. We add this to the effect from the unexpected asset market changes to give the funds' total under-valuation or surplus (Chart 2 and table 1).

Table 2

The surpluses as a percentage of GDP

Figures are per cent of GDP at market prices. A positive figure indicates a surplus, a negative shows undervaluation

	Redundancy effect	Asset price effect	Total
1972	3.3	–3.6	–0.3
1973	3.0	–11.5	–8.5
1974	2.9	–22.1	–19.2
1975	3.6	–13.5	–9.9
1976	4.3	–11.1	–6.8
1977	4.2	–6.2	–2.0
1978	3.9	–5.5	–1.6
1979	4.1	–4.5	–0.4
1980	5.2	2.5	7.7
1981	5.8	–0.2	5.6
1982	6.2	7.3	13.5
1983	6.8	10.0	16.8
1984	7.0	15.5	22.5
1985	7.1	15.1	22.2

because its trading position did not, in the Revenue's opinion, warrant such a cash boost. The company has however decided to suspend contributions to the end of the century, saving up to £150,000 a year.

Redfearn National Glass has been allowed to take £1.7 million out of its pension fund using the money to boost directly its liquid asset position. In this case the condition of both the company and the industry undoubtedly influenced the Revenue's decision.

There are substantial differences between the lump-sum clawback and contributions holiday approaches. Firstly, in terms of timing, companies who succeed in obtaining a cash transfer from their schemes benefit from an immediate liquidity effect. Companies that opt for a prolonged contributions holiday improve their balance sheet more gradually but may in turn be able to make borrowings capitalising the savings.

Secondly, there can be a difference in the taxation position between the two approaches. On the one hand, when a company claws back cash from its pension fund (as Refearn did), there is in principle a tax liability but in practice no tax is paid if there is sufficient unused tax relief. The company retains the tax advantage of continuing contributions. On the other hand companies taking a contributions holiday simply lose tax relief on contributions foregone.

Not only has the Inland Revenue adopted diverse approaches in different cases, but also the accountancy profession has avoided coming to terms with the pension fund surpluses. The recently issued statement of recommended practice (SORP) has little to say on the subject. It seems that because of the Revenue's uncertain attitude, the Accountancy Standards Committee are reluctant even to make recommendations about treatment of surpluses in the accounts of pension schemes.

Policy implications

The Revenue should state clearly that lump sum clawbacks will never normally be allowed. This is because companies with no mainstream corporation tax liability avoid tax on these clawbacks. To allow these companies to withdraw funds tax-free would therefore involve the use of pension tax relief for non-pension purposes, and this must be against the spirit of the pensions legislation.

Our view is that the Inland Revenue should go further. It should require all approved (i.e. tax exempt) pension funds to submit a clear statement giving estimates of any surplus. Although it is impractical to lay down a standard set of assumptions to be used in computing these surpluses, we recommend that such a set should be used as a benchmark with individual funds required to justify departures from the standard.

When the funds have reported the size of their surpluses, the Inland Revenue should require them to submit for approval their plans for eliminating the surpluses. This would usually involve a contributions holiday, perhaps combined with benefit improvements. On our cautious estimate for the surpluses of £50bn, their elimination over 10 years would involve reduced contributions or improved benefits of some £5bn per annum. This would in turn generate additional tax revenue, either by reducing relief on contributions or through tax payments on benefits. At a rate of 35 per cent (the standard corporation tax rate from next year) this would yield some £1¾bn per annum in extra tax, although the exact figure could be somewhat different because of the timing and form of the measures chosen by each fund.

The macroeconomic framework

The financial forecasts in this issue of Financial Outlook *are fully consistent with the LBS forecast published in the October edition of* Economic Outlook. *To produce that forecast, the LBS model was solved using consistent or 'rational' expectations – in other words agents' views about the future are assumed to be based on the information contained in the model itself rather than by a backward-looking 'adaptive' process. This summary highlights the main features of the forecast that determine financial flows.*

World background

The key assumption underpinning the forecast is that the dollar, already well below its first quarter peak, continues to fall. We assume a depreciation of 8½ per cent next year and about 5 per cent p.a. in subsequent years. Since we also assume that the price of oil remains constant in nominal dollars, this implies a significant fall in the oil price to consumers outside America. Commodity prices also remain weak, even in dollar terms, with the terms of trade moving against Third World primary producers as they attempt to expand exports to service and repay their debts. This downward pressure on costs helps to keep inflation steady, and we expect producer price increases to remain below 5 per cent this year and next, even though the world economy will by then be in the fourth year of recovery.

The moderate inflation outlook will encourage the authorities worldwide to take a slightly easier policy stance. The steady deceleration of monetary growth that has been under way since 1980 comes to an end next year, and we expect the world money supply to grow by just over 8 per cent p.a. thereafter. We assume that world interest rates remain close to present levels on average.

Against this background we expect world industrial production, which we estimate has decelerated from over 7 per cent last year to 3 per cent this year (almost entirely reflecting the sharp slowdown in the US), to pick up again to over 3½ per cent in 1986, settling back to steady growth in the 2-3 per cent range thereafter. The worst of the US slowdown is, we believe, behind us, while the European economies and Japan are still accelerating slowly out of recession.

Policy assumptions and the public sector

Our forecasts suggest that the authorities will broadly hit their medium-term target of a £7bn PSBR on the standard assumption that tax rates are unchanged from actual (or, in the case of Corporation Tax, announced) levels while income tax allowances and specific duty rates are uprated in line with prices. However, by stepping up asset sales the authorities have created room for tax cuts, and we assume a tax give-away worth just over £1bn in the 1986 budget implemented by increasing allowances by 12 per cent, well above the rate of inflation. This increase implies an on-going reduction in revenues in subsequent years, which is balanced by further asset sales.

The other major change to the forecast reflects the new funding policy which has been in operation since the summer and was confirmed in the Mansion House speech. We now assume that sales of gilts and National Savings certificates are broadly in line with the PSBR, and that the previous policy of overfunding the PSBR in order to hit the sterling M3 target is abandoned. One consequence of this change is that short term interest rates are higher than we previously forecast. Another is that the growth of sterling M3 remains well above the target for some while (the target has been formally suspended for the rest of this year). This projection assumes that short term interest rates are allowed to fall, although we now expect the decline to be slower than we predicted in July, and since we now forecast lower inflation the rates are significantly higher in real terms. Counter-inflationary policy currently rests, as the authorities made clear in the context of the Group of Five initiative to bring down the dollar, on a strong exchange rate, supported by high short-term interest rates. The change in funding policy announced in the Mansion House speech is entirely consistent with that approach.

The components of demand and output

The weakness of the exchange rate earlier this year produced a surge of exports. With imports growing slowly following the resumption of domestic coal production, the external sector makes an important contribution to the 3½ per cent growth of GDP that we expect this year. Next year we expect slower export growth, reflecting the recovery of the exchange rate, while imports pick up to resume their normal relationship with GDP. Net trade thus makes a negative contribution to GDP growth. Investment is also expected to slow down – the phasing out of initial allowances brought capital spending forward to 1984 and 1985, leaving less in 1986. However, we expect consumption to accelerate, as real incomes are boosted by a sharp slowdown in inflation that is not quickly matched on wages. The net result is that output growth falls to 2½ per cent next year. Adjusted for the effects of the coal dispute, the underlying growth rate is little changed, but there is significant change in the composition of demand, with a smaller contribution from investment and net exports and a larger contribution from consumption.

Personal sector

The return to a high-interest-rate, high-exchange-rate policy has important consequences for inter-

percent changes on previous year

	1984/5	1985/6	1986/7	1987/8	1988/9
Gross domestic product. Output	2.9	3.7	1.8	2.5	2.0
Price of private consumption	5.2	4.3	4.7	4.4	3.9
GDP. Expenditure at factor cost	6.7	9.2	6.4	7.5	6.8
Personal sector					
Personal disposable income	7.1	8.7	7.6	6.6	6.2
Consumers' expenditure	6.6	7.7	8.5	8.1	6.9
Personal sector GDFCF	5.5	8.7	13.3	10.5	9.1
NAFA. Personal sector (£bn)	11.1	13.6	11.3	7.6	5.8
Wages & salaries per employee	6.2	8.6	6.6	6.6	5.9
Total employment	1.4	1.1	1.2	1.4	1.5
Personal savings as % disp income	11.8	12.6	11.9	10.6	10.0
Company sector					
Gross trading profits	20.7	4.7	10.0	6.0	3.8
Savings: company sector	21.9	5.3	13.5	7.6	7.3
Company sector GDFCF	24.5	12.6	4.7	13.1	13.9
NAFA: Company sector (£bn)	8.1	9.0	10.2	9.6	8.7
Unit labour cost in manufacturing	4.1	6.2	6.9	3.9	2.9
Producer price: manuf. output	6.1	5.1	4.6	5.4	4.4
Public sector					
General government consumption	7.6	6.8	7.1	6.3	5.5
Public sector GDCF	-3.8	-15.0	-2.0	1.3	1.7
Public sector receipts	6.4	6.6	4.5	5.9	5.1
NAFA: Public sector (£bn)	-13.1	-10.4	-11.6	-10.1	-9.5
Overseas sector					
Exports of goods and services	16.6	7.8	9.1	9.4	7.3
Imports of goods and services	22.1	1.6	13.1	12.8	9.4
Current balance of payments (£bn)	-0.6	4.8	2.1	-1.2	-3.9
World exports of manufactures	8.6	6.0	5.3	4.4	3.9
Competitiveness: relative costs	-10.3	6.5	-3.0	-3.5	-1.5
Terms of trade: goods and services	-2.4	1.9	-1.9	-0.4	0.6

sectoral flows of funds. A strong exchange rate generally benefits consumers at the expense of producers. It puts downward pressure on prices, and until this is transmitted through into wages, real incomes rise at the expense of profits. Since it also takes time for the higher real incomes to feed through into consumption, there is a short-term boost to personal savings which are sustained in the longer term by the higher interest rates. For these reasons we have significantly revised upwards our forecast of the personal sector financial surplus in 1985-6. We expect consumer spending to grow by 7.7 per cent in value terms, compared with 9.4 per cent forecast in June, with the change largely accounted for by lower prices. So although we expect some of the extra cash available to the personal sector to go into real assets, there is a significant increase in their acquisition of financial assets in the current financial year.

In 1986-7 we expect the personal sector surplus to dwindle. Although persons benefit next year from the assumed tax cuts, we are forecasting slower growth in nominal incomes as wage settlements start to reflect the slowdown in retail price inflation. The lower inflation rate helps to bring down the savings ratio, so consumption growth rises even though nominal incomes decelerate. Since interest rates are forecast to fall in the course of next year, the recovery in the private housing market accelerates and personal sector investment grows by over 13 per cent in value terms. The surplus left over for acquisition of financial assets thus shrinks from £13½bn to £11¼bn. In later years we expect the personal sector surplus to go on falling, mainly because the savings ratio, which is well above the long-term equilibrium level consistent with actual and forecast inflation rates, comes steadily down, helped in some years by real reductions in contributions to pension funds, net of benefits.

Company sector

Beside the strong personal sector surplus, company finances are considerably weaker both during 1985-6 and beyond. In recent years wage increases have been steady at around 9 per cent but inflation has nevertheless declined because unit costs in manufacturing increased by only 3 per cent or less. This was achieved by once-for-all productivity gains – associated with the elimination of unproductive

capacity – that are now coming to an end. Cost inflation is thus forecast to accelerate, but the strong exchange rate prevents a parallel increase in producer prices. The effects on profits are mitigated this year by the post-coal-strike rebound in output, and associated productivity gains. Even so profit growth slows to little over half the near-20 per cent rate recorded over the past two years, and we forecast a further slowdown next year.

Despite slower profit growth we expect the company sector to continue to run substantial surpluses over the forecast period. An important reason for this is the sharp slowdown in investment growth that we forecast for next year. We also expect the interest burden on the company sector to stabilise in the course of next year – it rose sharply last year – and to fall in 1987 as interest rates come down.

Overseas sector

With the personal sector financial balance at high levels in 1985-6 and 1986-7, and companies managing to hold their overall financial position, the main counterpart is a financial deficit for the overseas sector, i.e. a current account surplus. This surplus has re-emerged this year as trade flows have recovered from the effects of the coal dispute. Imports are barely growing as domestic production once again replaces imported fuels. This post-strike rebound has to some extent disguised an underlying deterioration in the external position. The strength of the exchange rate and the slowdown in world trade this year have reduced export growth, and when imports resume their normal growth next year the current account deteriorates. The deterioration is slow, however, because we are forecasting a pick up in world trade next year as the recovery in Europe and Japan accelerates while the slowdown in the US has now largely run its course. Thus it is not until 1987 that the first annual deficit is recorded, and even then the effects on the current account are mitigated by an improvement in the terms of trade. This reflects a worldwide trend for the prices of manufactured goods to rise faster than those of raw materials.

Inflation

All the news since we completed our June forecast has pointed to a lower rate of inflation. The most important single factor has been the rise in the exchange rate, but this has been compounded by the weakness of commodity prices (including oil) worldwide, and by the fall in the dollar itself. Thus the price of imported basic materials, which reflects all the above factors, is estimated to be nearly 9 per cent below year-earlier levels in the third quarter. Other significant recent statistics are for consumer price inflation, only 4½ per cent in the second quarter compared with the much more widely published 7 per cent rise in retail prices, and the CBI survey evidence, which has shown a sharp fall in the percentage of firms expecting to raise their prices in the New Year.

For all these reasons we are forecasting a fall in the rate of (consumer prices) inflation from 5¼ per cent last year to 4¼ per cent in the current financial year. The fall in retail price inflation, which was boosted by the rise in mortgage interest rates earlier this year and will be correspondingly reduced as they come down, is much sharper, and we expect some deceleration in wages next year as settlements respond. However, because productivity growth from now on is expected to be much lower than it has been in the past there is no further fall in inflation, which remains in the 4-4½ per cent range over the forecast period.

P.W.R.

Interest rates and asset prices

Asset prices in the LBS model – the exchange rate and price indices for gilts and equities – are determined as the levels which bring supply and demand into line, with asset yields, expectations and wealth in turn affecting demand. To show the importance of supply and demand, we introduce two new tables in this issue of Financial Outlook*. One shows transactions in gilts by sector, the other shows transactions in equities and other company securities.*

UK short-term interest rates

The Mansion House speech announced that with the ending of overfunding, short-term interest rates would replace excess gilts sales as the major instrument of monetary control. The implications of this policy change for short term interest rates are particularly uncertain because the target for sterling M3 has been suspended; M0 has grown closer to the bottom end of its range than the top; and the exchange rate since the speech has fallen against most currencies but this has been largely offset by the general weakness of the dollar.

Given these apparently conflicting signals, we have revised up our forecast for bank base rates from the levels that we expected in July, but we have retained the profile of a gradual decline in the course of next year. We are forecasting a rate of 9 per cent at the end of 1986, falling further to 8 per cent in 1988. This is just above the level of 7.5 per cent that we predict for our weighted average of world short-term rates. By contrast in our July forecast, bank base rates reached 8 per cent by the end of next year. We have also revised down our inflation forecast so that in real terms the upward revision to interest rates is larger. (See 'Macroeconomic Framework' for our projections of the world economy and UK inflation rates).

From next year onwards the standard rate of corporation tax will fall to 35 per cent, reducing the tax relief on corporate borrowings. Our figure of 9 per cent for base rates next year implies the same post-tax cost to companies as a base rate of 12.2 per cent under the old corporation tax rate of 52 per cent.

The gilts market

The gilts market table shows the reduction in funding announced in the Mansion House speech. In the current financial year, we forecast a PSBR of £8.0bn and we expect National Savings to raise £2.6bn, just below the Chancellor's original target of £3bn. Our figure for total gilts sales is £5.7bn giving total funding of £8.3bn, just fractionally above our PSBR figure. The table shows the large gilts purchases that the overseas sector has made in the course of this year. It should be noted that the definition of 'total funding' used in the gilts market table includes National Savings and gilts sales not only to the UK non-bank

The gilts market

£ billion

	Stock	Actual				Forecast				Stock
	81Q1	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	89Q1
Gilts purchases by sector										
Personal sector	15.0	1.6	0.6	1.9	3.3	1.2	1.4	–0.3	–0.3	29.0
Industrial & Commercial Companies	1.3	–0.2	0.2	0.5	–0.2	0.1	0.3	0.3	0.3	3.6
Overseas sector	6.5	0.2	0.6	1.1	1.5	2.4	0.0	–0.5	–0.6	15.9
Pensions funds and insurance companies	30.8	4.3	3.2	5.2	5.3	4.1	6.1	7.8	7.8	97.7
Monetary sector	13.8	0.5	–2.7	–1.0	–0.1	–1.1	–0.9	–0.6	–0.5	17.1
Unit and Investment Trusts	0.4	0.0	0.1	0.2	0.1	0.2	0.2	0.2	0.2	1.4
Building Societies	12.6	1.1	0.9	1.7	0.9	–1.2	–1.0	–0.8	–0.8	15.2
Total purchases	80.5	7.5	2.9	9.7	9.9	5.7	6.0	6.0	6.0	179.9
Gilts sales by government	80.5	7.5	2.9	9.7	9.9	5.7	6.0	6.0	6.0	179.9
National Savings	15.3	4.2	3.0	3.3	3.1	2.6	1.7	1.2	1.3	35.7
Total funding	95.7	11.8	6.0	13.0	13.0	8.3	7.7	7.2	7.3	215.5
Memorandum item:										
PSBR	—	8.8	9.3	9.3	10.5	8.0	7.5	7.4	7.1	—

private sector and abroad, but also to UK banks; but it excludes all bill transactions and tax instruments.

For 1986-7 and beyond, we forecast some reduction in the money raised through National Savings, as the Chancellor tries to reduce pressure on the retail savings market. Given this forecast and our expected PSBR of £7.5bn next year and slightly less in later years, gilts sales of £6bn per annum are needed to meet the Chancellor's aim of funding the PSBR exactly (using the definition of funding shown in the table).

These figures for gilts sales are substantially lower than in the two previous years, and are also about £1bn per annum below the level that we forecast in July. As a result we are now significantly more optimistic about gilts prices (interest rates and asset prices table). Following the rise in the market over the last year, the model shows a further rise in response to the reduced rate of sales. This reflects the strong influence of supply and demand factors in the model and occurs despite the upward revision to our forecast for bank base rates.

However, this forecast for gilts prices must be qualified. It was prepared just before the increased rate of asset sales was announced in the Autumn Statement. We have revised up our forecast of asset sales since July, but only to £3.5bn per annum (Equity Market table). In our forecasting model, gilts prices are affected by conditions in the equity market and the higher figure for asset sales announced by the Chancellor is likely to remove some of the buoyancy shown for the gilts market.

The equity market

The equity market in 1985-6 is dominated by two major factors. Pension funds and insurance companies appear to have switched strongly into equities. This is partly because of the cutback in gilts sales and it also reflects their greatly reduced level of overseas investment. The other major factor in the equity market this year is the continuing high rate of new issues by companies, which are taking advantage of the buoyant level of equity prices. Supply also comes from government asset sales estimated at £2.5bn for the year.

In addition to the demand from the long-term institutions, purchases have been boosted by company acquisitions, which could exceed the £2.4bn shown in the table. The personal sector, although a net seller, is expected to dispose at a slower rate in real terms than its historical average for the last twenty years. As a result, demand pressure has tended to outstrip supply and prices have risen sharply.

For next year, the rate of corporate acquisitions is expected to slow but institutional demand remains strong, reflecting reduced gilts sales and low purchases of overseas assets. On the supply side, the rate of new issues by companies slows. In our forecast this is only partly offset by higher government asset sales and as a result supply and demand remain approximately in line and real equity prices remain little changed next year. The government's higher figure for asset sales implies a somewhat

The equity market

£ billion

	Stock 81Q1	Actual 1981/82	1982/83	1983/84	1984/85	Forecast 1985/86	1986/87	1987/88	1988/89	Stock 89Q1
Equity purchases by sector										
Personal sector	42.3	-2.5	-3.2	-3.3	-2.5	-2.2	-2.7	-4.4	-4.8	91.9
Industrial & Commercial Companies (acquisitions)	13.4	1.3	1.5	2.5	3.8	2.4	1.3	1.0	0.9	42.7
Overseas sector	8.2	1.2	0.6	1.2	3.4	0.3	0.8	0.9	1.1	33.2
Pensions funds and insurance companies	47.8	3.2	3.4	2.5	4.4	6.3	5.9	7.5	7.6	171.8
Monetary sector	2.2	-0.1	-0.1	0.7	-2.0	0.0	0.0	0.0	0.0	3.5
Unit and Investment Trusts	8.2	-0.3	-0.2	0.2	0.4	0.5	0.6	0.6	0.6	21.0
Total purchases	122.1	2.9	2.0	3.8	7.5	7.4	5.9	5.5	5.3	364.1
Equity sales by sector										
Government sales	0.0	0.4	0.1	-1.1	-2.1	-2.5	-3.5	-3.3	-3.0	-13.3
Industrial and Commercial Companies issues	-91.1	-3.1	-1.7	-2.2	-4.5	-4.6	-2.2	-2.0	-2.0	-292.5
Monetary sector and OFI issues	-31.1	-0.1	-0.4	-0.5	-0.9	-0.3	-0.3	-0.3	-0.3	-58.3
Total sales	-122.1	-2.9	-2.0	-3.8	-7.5	-7.4	-5.9	-5.5	-5.3	-364.1

weaker outlook for the equity market. Beyond 1986-7, institutional demand remains strong but the personal sector steps up its rate of disposals and rises in equity prices fall slightly behind the rate of inflation.

The exchange rate

The short-term outlook for the exchange rate in our forecast is heavily influenced by our view that UK short-term interest rates, although falling, will be well above world rates. In the model this differential persuades investors to hold sterling even though they expect it to decline. We solve our model on the assumption that such expectations are fulfilled, and so we are forecasting a fall in sterling over the course of the next two years, while the interest rate differential persists. This fall in sterling implies a rise in the index for the price of foreign currency (interest rates and asset prices table).

The exchange rate is not just determined by interest rate differentials. It is also influenced by shifts in wealth between UK residents and the rest of the world, which can be caused by factors affecting the current account directly such as oil price shocks, or by shocks to asset prices themselves. Despite these complications, relative interest rates are important and therefore we expect a relatively stable exchange rate once our interest rates move close to world levels in two years time.

G.B.K.

Interest rates and asset prices

	1980/1	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Interest rates – percent p.a.									
UK banks base rate	15.5	13.3	11.2	9.4	10.7	11.5	9.3	8.0	8.0
Building Society deposit rate (grossed-up)	14.5	13.6	11.4	10.0	10.7	11.3	9.6	8.2	8.1
Equity yield (FT industrial ordinary shares)	7.4	5.8	5.1	4.6	4.7	4.1	3.8	3.9	3.9
20-year gilts yield	13.6	14.9	11.8	10.0	10.2	9.4	8.7	8.6	8.4
Weighted average of world 3-month interest rates*	12.0	12.6	10.5	8.5	8.7	7.5	7.5	7.5	7.5
US dollar corporate AAA bond yield	13.2	15.5	12.8	12.5	13.5	12.0	11.7	11.0	11.0
Indices – average of end quarters									
FT industrial ordinary share index	478	538	601	762	884	1035	1085	1113	1161
FT government security index (dated over 15 years)	116	104	132	141	135	149	162	164	168
Exchange rate (in sterling per unit of foreign currency)**	96	116	132	146	170	164	173	177	176
US Standard and Poors composite index	128	120	131	164	164	191	198	206	214

*Weights are approximately 50 per cent US Dollar, 20 per cent DM and 10 per cent each for Swiss Franc, French Franc and Yen
**A rise in this index indicates a depreciation of sterling; a fall indicates an appreciation. The index is weighted by UK portfolio holdings overseas, giving the US dollar a higher weight than in the trade-weighted index.

Monetary Aggregates

If the shift in policy announced in the Mansion House speech is implemented, then the system originally intended to operate under Competition and Credit control will finally have been introduced nearly a decade and a half later. The Competition and Credit control changes were intended to replace a system of quantitative controls on bank lending and strict reserve ratios by control through interest rates. It failed because the government was not prepared to see interest rates rise to the level that was necessary for control; and the adoption of a very expansionary fiscal policy at the same time implied that the required level of interest rates was very high.

The present system of monetary control also involves almost unrestricted bank lending (with some remaining peculiarities such as the restrictions on bank loans secured on houses) and very low reserve ratios. These two aspects of the system were introduced in 1981, since when some use of short term interest rates as an instrument of control has been combined with overfunding. The latest policy change, by supposedly moving to total reliance on interest rates, brings us close to the Competition and Credit control system as it should have been.

Reminders of Competition and Credit control immediately suggest other disturbing aspects of recent monetary history. The explosion of sterling M3 which followed was accompanied by relatively slow growth of M0 (as far as it can be measured), and thus the broad aggregate successfully predicted the future inflation while the narrow aggregate failed. In 1985-6 we are again seeing rapid growth of sterling M3 accompanied by slow increases in M0. The Chancellor points to the current decline of inflation as evidence of the success of policy, yet the experience of the Competition and Credit control era suggests that the danger lies some two years or so into the future.

Despite these similarities, there are major differences between the two periods. Nominal interest rates are far higher, the current base rate of 11½ per cent contrasting with an average of 5.3 per cent in 1971-2 and 6.8 per cent in 1972-3. In real terms, on any measure looking forward or back, current rates are far higher, and the differential between UK and overseas rates is also much greater. On a post-tax basis the difference is even greater because the personal sector enjoyed full relief on most loans over much of the Competition and Credit control period. The level of interest rates is important not only in itself, but also as an indicator that the government is now prepared to use the instrument which it failed to apply in 1971 and 1972.

The evidence from the exchange rate is less clear. Despite the comments from industry, the price of manufactured goods produced in the UK relative to our competitors' is now only some 6 per cent above the level recorded at the start of Competition and Credit control (although there are considerable problems in making a satisfactory comparison over this length of time). Any depreciation from now would increase the similarity with the 1971 to 1973 period, when the total reduction in the effective exchange rate was some 17 per cent over the two years from the introduction of the Competition and Credit control measures.

The existence of quantitative monetary targets also marks a significant difference from the 1971 to 1973 period. Although the sterling M3 target has been suspended, the Chancellor has promised to announce a new target next year, although he will presumably accept this year's base drift as a bygone. A further key difference between now and the Competition and Credit control period is that fiscal policy is far tighter, the results of any comparison depending on the adjustments made for asset sales, inflation and the state of the cycle. Less reassuring, one of the two CBI capacity indicators suggests that manufacturing industry is closer to capacity limits than at the start of the Competition and Credit control period.

Provided the government is prepared to use short term interest rates as its only instrument of monetary control, then the experience of 1985 and 1986 should be the opposite of 1971 and 1972. M0 will be a better indicator of prices than sterling M3. However, if the government acts in the way it did in 1971-2, by failing to use this instrument, then the experience is likely to be repeated.

Our table for sterling M3 has been modified to show sterling non-deposit liabilities, with external and foreign currency counterparts now including foreign currency bond issues by the banks. The size of these bond issues is shown in the monetary sector section of *Financial Outlook*. Debt sales to the overseas sector, which are included with sales to the non-bank private sector in the latest official figures, are included here under foreign currency and external counterparts.

G.B.K.

Counterparts to sterling M3

£ billion

	Actual				Forecast			
	1981/2	**1982/3**	**1983/4**	**1984/5**	**1985/6**	**1986/7**	**1987/8**	**1988/9**
PSBR	8.8	9.3	9.3	10.5	8.0	7.5	7.4	7.1
Debt sales to UK NBPS - bills	-0.1	0.4	-0.1	-0.2	-1.2	-0.3	0.0	0.8
Debt sales to UK NBPS - gilts	-6.8	-5.1	-9.6	-8.4	-4.4	-6.9	-7.1	-7.1
Other debt sales to UK NBPS	-4.6	-3.8	-3.0	-3.8	-3.3	-2.0	-1.6	-1.7
Bank loans to UK private sector incl BoE bills	14.9	15.0	15.7	18.8	18.4	17.4	16.0	15.2
Foreign currency and external counterparts	-0.9	-3.2	-2.6	-1.7	-1.3	-0.9	-2.2	-4.0
Change in sterling non-deposit liabilities	-1.5	-1.9	-2.3	-2.7	-4.6	-3.6	-4.0	-4.9
Change in sterling M3	9.8	10.7	7.3	12.4	11.4	11.2	8.5	5.6
UK private sector deposits	9.2	8.9	7.5	11.6	10.8	10.6	8.1	5.0
Notes and coin	0.4	1.4	0.2	0.8	0.5	0.7	0.4	0.5
Total: Sterling M3	9.6	10.3	7.7	12.4	11.4	11.2	8.5	5.6
Stock, end year	84.3	94.2	103.8	116.4	127.8	139.2	147.7	153.3
Percentage change	14.4	12.2	8.2	11.9	9.9	8.8	6.1	3.8

Sterling M3 foreign currency and external counterparts

£ billion

	Actual				Forecast			
	1981/2	**1982/3**	**1983/4**	**1984/5**	**1985/6**	**1986/7**	**1987/8**	**1988/9**
UK Banks £ loans to overseas net of overseas £ deposits	-0.3	-0.5	-0.8	-1.4	3.5	-0.5	-2.3	-4.0
UK Banks f.c. loans net of f.c. deposits	0.3	-0.4	-0.6	1.6	-2.6	-0.2	0.3	0.1
Public sector external finance								
Gilts sales to overseas	-0.2	-0.6	-1.1	-1.5	-2.4	0.0	0.5	0.6
Treasury and L.A. bill sales	0.1	-0.2	0.0	-1.1	0.1	-0.2	-0.6	-0.7
Other external finance incl. f.c. bank loans and change in reserves	-0.8	-1.6	-0.2	-0.4	0.0	0.0	0.0	0.0
Total: Foreign currency and external counterparts to sterling M3	-0.9	-3.2	-2.6	-1.7	-1.3	-0.9	-2.2	-4.0

Wide monetary base M0

£ billion

	Actual				Forecast			
	1981/2	**1982/3**	**1983/4**	**1984/5**	**1985/6**	**1986/7**	**1987/8**	**1988/9**
Notes and coin in circulation with public	0.4	1.4	0.2	0.8	0.5	0.7	0.4	0.5
Notes and coin at banks	-0.3	-0.2	0.1	0.1	0.0	0.1	0.1	0.1
Bankers operational deposits at BoE	0.2	-0.1	0.0	-0.1	0.2	0.0	0.0	0.0
Change in M0	0.3	1.1	0.3	0.8	0.7	0.8	0.5	0.6
Stock, end year	11.9	12.6	13.1	13.9	14.6	15.4	15.9	16.5
Percentage change	2.6	9.2	2.4	6.1	5.0	5.5	3.2	3.8
Target range, March 1985 FSBR, percent	—	—	—	—	3-7	2-6	1-5	—

The Sectors

Personal Sector

Major issues

- The personal sector build up of liquid assets over the last year shows a higher proportionate increase in the flow of funds to banks than to Building Societies than in the previous five years. In the future, with a reduction in the rate of accumulation of liquid funds, will banks suffer proportionately more than Building Societies?
- 1984-5 showed an uncharacteristic increase in personal sector holdings of public debt. This has paralleled the US personal sector record purchase of Federal debt in 1984. What underlay this phenomenon in the UK and is it likely to continue?

Recent developments

The rise in personal sector financial surplus can be traced directly to the rapid rise in disposable income over the last year. This is the consequence of larger incomes from wages and salaries, and also from dividends and interest following on from the year's high interest rates and buoyant profits. Consumption has not been keeping pace with the current acceleration in money incomes and in fact, with a small drop in consumer spending in the first quarter of this year, personal savings and the savings ratio have risen. On this it is worth noting the following technical point. The 'other assets' figure of over £8½bn in 1984-5 is largely due to the unidentified items in the National Accounts, with £4bn in the first quarter of 1985 alone. One interpretation of this is that the recorded £16½bn may underestimate the actual amount of personal savings. We have reduced the contribution of these unidentified items over our forecast period and have significantly revised upwards by about £3bn our forecast of personal savings for 1985-6.

This boost in personal savings coincides with the concerted effort made by the banking sector to recover the market share it had lost to Building Societies. The innovative features introduced include high interest, instant access accounts (see *Financial Outlook* July 1985, for details). With a significant rise in bank deposits in 1984-5, there is evidence that the banks have succeeded in stemming recent rapid flow of funds into Building Societies. Thus the dramatic loss of over £4bn in flows into bank deposits in 1983-4 has more or less been recovered in the last year.

The non-mortgage borrowing by individuals that had declined in the three months to February has picked up in the last quarter. This reflects the recent rise in consumer spending with a one per cent rise in the third quarter over the first, on provisional data, and 3½ per cent on a year earlier. The buoyancy of mortgage borrowing relative to other bank loans is partly because many of the latter are at fixed interest rates and are therefore not as attractive when interest rates are expected to fall further. Inflows to life assurance and pension funds has remained high at the projected level of about £17bn in 1984-5. The unprecedented rise in 1984-5 was due to special factors: the introduction of MIRAS and anticipation of removal of LAPR in 1983-4 and fears of pension fund tax in 1984-5. Furthermore, large interest and dividend earnings by the institutions in the last year automatically go toward boosting this inflow.

Our July forecasts substantially underestimated the private sector purchases of gilts and long-term public debt in 1984-5. The actual private sector holdings rose by £3.3bn as opposed to our projection of about £1.6bn, in a way that paralleled the US personal sector record purchase of Federal debt in 1984 (see *Financial Outlook* July Briefing 2). In the US, the personal sector purchase of £74bn Federal debt in 1984 was seen to compensate for the lack of demand from commercial banks due to the large loan demand on them. In the UK towards the tail end of the government's overfunding policy, in 1984 third quarter and again in 1985 first quarter, a considerable bulk (£0.8bn and £1bn respectively) of index linked gilts were placed on the market. These are a particularly attractive addition to personal sector portfolios because of the tax treatment. The announcement early in 1985 of the full exemption of gilts from capital gains tax provided an added incentive to acquire gilts as the tax change, if anything, augured a rise in their price. Finally, the issue of index linked gilts coincided with large sales of equities by the personal sector (obscured by the BT flotation), to take advantage of the high prices. Despite the above factors, it is not completely clear why personal sector demand for government debt was so strong in 1984-5.

The outlook

The anticipated tax cuts next year will raise personal disposable income and as consumer spending reacts slowly to this, we have forecast a continuation of the current high level of personal savings well into 1986-7. Beyond 1987 we expect consumers to respond to forecast stability of inflation and falling interest rates by reducing their savings ratio.

In the current forecast, there is also strong projected growth in private sector fixed investment. Investment by unincorporated businesses in non-residential fixed assets rose by 16 per cent in the first quarter of this year from the previous quarter and over 31 per cent on a year earlier. We have revised up our July forecast for this item, to reflect this rapid growth in the immediate past. Residential investment will grow apace, with the housing market boosted by growth in consumer incomes and the anticipation of falling interest rates.

The current build up of liquid assets in the form of high interest bank and Building Society deposits is expected to slow in 1986-7 as consumers accept that the underlying inflation rate has fallen and the savings ratio falls. Inflows to life assurance and pension funds grow at a slower rate than in the recent past, reflecting the overvaluation of these funds discussed in detail in the 'Viewpoint'.

The issues resolved

There is every indication that the build up of personal savings is due to lags in the adjustment of permanent income and consumption rates, which may partly reflect the slowness of the fall in inflationary expectations. The accumulation of liquid assets in the form of bank and Building Society deposits will slow next year as inflationary expectations fall. We also envisage a temporary loss of banks market share of the personal liquid asset market next year. This is because individuals will by then have completed most of the stock adjustment into the new accounts introduced this year. However, it is possible that the banks will react to this by introducing further new savings instruments.

The uncharacteristic strength of personal sector holdings of government debt in 1984-5 was conjectured to have been partly the outcome of the government's issue of indexed and low coupon gilts attractive to personal sector portfolios, in the tail end of its overfunding policy. With the latter having come to a close earlier this year, the end of major special factors that boosted the strength of personal sector demand for gilts justifies our forecast of reduced purchases from now on.

S.M.M.

Sources and uses of funds: Personal sector

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
SAVING AND CAPITAL TRANSFERS											
Saving	217.8	23.3	22.9	23.9	26.5	30.8	31.1	29.6	29.8	99.7	535.4
Net Capital Transfers	—	0.3	0.6	1.6	1.2	0.7	0.7	0.8	0.8	—	—
INCREASE IN BORROWING											
Bank Borrowing (excluding house loans)	14.9	4.3	4.7	4.3	4.8	5.8	5.0	5.2	5.4	1.7	56.1
House Purchase Loans, Total	54.3	10.4	15.1	14.7	16.8	16.4	17.1	17.3	17.2	0.0	179.4
Hire Purchase	4.3	0.0	0.5	0.7	0.5	0.5	0.8	0.5	0.3	-1.7	6.5
Other (net)	-4.8	0.9	2.1	4.3	8.6	5.0	-0.5	-0.9	-0.5	-9.1	4.6
TOTAL SOURCES	286.6	39.3	45.9	49.4	58.4	59.2	54.4	52.5	53.1	83.9	782.1
USES											
INVESTMENT AND STOCKS											
Investment and Stocks	—	10.8	13.6	15.9	16.7	17.9	20.6	22.7	24.8	—	—
ACQUISITION OF FINANCIAL ASSETS											
Notes and Coin	8.0	0.5	1.3	0.1	0.6	0.3	0.5	0.2	0.4	0.0	11.9
Bank Deposits	37.4	3.5	5.6	1.0	4.1	6.8	3.0	4.4	4.5	6.1	75.7
Building Society shares	51.4	7.0	10.3	11.8	12.3	11.8	10.6	9.7	7.3	0.0	132.4
Gilts and other long-term public debt	15.0	1.6	0.6	1.9	3.3	1.2	1.4	-0.3	-0.3	4.5	29.0
UK Debenture, Ordinary and Pref. Share	42.3	-2.5	-3.2	-3.3	-2.5	-2.2	-2.7	-4.4	-4.8	75.2	91.9
Net Foreign Currency assets	4.5	0.2	-0.1	1.4	1.6	2.0	0.2	-1.2	-1.5	4.0	11.2
Unit Trust Units	3.3	0.1	0.2	0.8	0.5	0.8	0.8	0.8	0.8	6.7	14.9
Nat. Saving Certificates	8.7	3.6	1.2	1.3	1.7	1.0	0.7	0.3	0.2	0.0	18.7
Other National Savings	6.5	0.6	1.8	2.0	1.4	1.6	1.0	1.0	1.1	0.0	17.0
Trade Credit (net)	2.1	0.0	0.8	1.3	1.3	0.2	0.3	0.3	0.2	0.0	6.5
Equity in Pension Funds and Insurance Cos.	106.5	13.2	13.6	14.6	16.6	17.2	17.9	18.9	20.4	130.3	369.2
Accruals Adjustment	0.8	0.4	0.1	0.5	0.8	0.6	0.2	0.1	0.1	0.0	3.7
TOTAL USES	286.6	39.3	45.9	49.4	58.4	59.2	54.4	52.5	53.1	83.9	782.1
MEMORANDUM ITEMS											
Financial balance	217.8	12.7	10.0	9.6	11.1	13.6	11.3	7.6	5.8	236.0	535.4
House Purchase Loans by Sector:											
(a) From Banks	3.1	3.1	4.8	3.9	2.5	3.0	3.4	3.6	3.7	0.5	31.7
(b) From Building Soc's	44.4	5.9	9.6	11.0	14.4	13.2	12.8	12.8	12.9	0.0	137.1
(c) From Other	6.8	1.4	0.6	-0.2	-0.1	0.2	0.9	1.0	0.6	-0.5	10.6

Industrial and Commercial Companies

Major issues

- Has there been a breakdown in the relationship between profits and investment?
- Will bank borrowing fall as capital allowances reach their lowest effectivel level, next year?
- Will the recent burst of new issues on the equity market be maintained?

Recent developments

Gross trading profits rose by 23 per cent in 1984-5. This reflects a continuation of the trend since 1981-2 and the inclusion of British Telecom profits for the first time (albeit only for part of the year). Even without the £300 million which the latter is thought to have added, profits growth remains strong. This is not immediately apparent from the most recent data, which show profits (including stock appreciation) to be broadly unchanged in the second quarter of this year. Within the total, North Sea oil profits were weak due to the recovery of sterling against the US dollar, the fall in the dollar price of oil and lower production in the North Sea. Non-oil company profits, once stock appreciation is excluded, rose sharply in the second quarter to a record level.

Non-trading income benefitted from higher interest rates and the lower exchange rate gave a small boost to overseas earnings at the end of the last financial year. Corresponding to the increase in interest receipts, interest payments rose by 35 per cent in 1984-5. With dividend and tax payments 25 per cent higher, savings growth fell below profits growth.

The relationship between savings and fixed investment for the company sector as a whole was extremely close until mid-1983 when investment growth lagged behind savings allowing companies to accumulate large financial balances (Chart 1). At first sight this would suggest that companies (all companies are shown to eliminate effects from leasing) now prefer to build up liquidity rather than their capital stock. However, if the definition of investment is widened to include acquisition of domestic and overseas firms then investment growth has matched the rise in savings since 1983. On this measure of investment internally generated funds have not been adequate and this provides part of the explanation why companies have continued to seek external finance on such a scale. There was a sharp increase in ICC fixed investment (net of leasing) in the last half of 1984-5 with this being continued into the second quarter of this year (see recent developments table). This is partly a response to the approaching further reduction of capital allowances, although it is difficult to ascertain just how much investment has been brought forward.

Our last forecast underestimated the voraciousness of ICC demand for external funds in 1984-5. Bank borrowing reached £7.5bn and £1bn more than this was raised through share issues and foreign currency borrowing. The latest data show a levelling off of bank lending in sterling although new issues were buoyant in the second quarter of 1985. This is consistent with firms wishing to finance a higher level of non-leasing investment but delaying new equity issues during the British Telecom flotation when short term interest rates were falling and so bank borrowing had a temporarily large comparative advantage. As in 1983-4 ICCs used increased funds to rebuild liquidity but also increased investment throughout 1984-5 in UK equities and in overseas investment. The latter being exceptionally large even if we take account of ICI's acquisition of Beatrice chemicals at the beginning of the year.

It should be noted that a net £9.6bn of funds are unaccounted for on the uses side, although this balancing item is influenced by errors and omissions in income, expenditure and appropriations as much as underrecording of financial acquisitions. It also makes the above analysis particularly uncertain.

Recent developments

	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1984/85 Total
Fixed investment (£bn)	4.7	5.1	5.6	5.6	20.0
(% change in brackets)	(20.6)	(21.5)	(26.7)	(21.6)	(22.3)
Savings (£bn)	8.0	7.6	8.7	7.8	31.6
(% change in brackets)	(13.1)	(15.9)	(14.8)	(7.7)	(18.7)
Stockbuilding (£m)	-61	75	-372	354	-670
Bank deposits (flows)					
Sterling (£m) (sight & time)	1570	814	552	60	3564
Foreign currency (£m)	-81	1410	-243	376	-1326[1]
Net new issues (£m)	304	287	1035	1385	2102
	Q3 15 Aug	**Q4 21 Nov**	**Q1 20 Feb**	**Q2 16 May**	
Bank lending in sterling[2]					
Total manufacturing (£m)	+450	+1594	+466	+121	2888
Distribution[3] and construction (£m)	+199	+795	+785	+405	1864

[1] fell for first time since 1976
[2] Banking quarters
[3] Distribution is retail motor trades, plus other retail distribution, plus wholesale distribution

The outlook

With average earnings growth outpacing prices we expect profit margins to be squeezed over this financial year. Although interest rates are expected to decline by 2 percentage points during 1985-6 inflation also declines so there is a high real cost of servicing debt. As a result there is little growth in savings. We are now forecasting significantly lower fixed investment compared to our July projection and consequently the ICC NAFA is hardly changed. In addition we expect some fall in net direct investment overseas and in investment in UK equities, from the high levels of last year. This is largely because the prices of UK and US equities are substantially higher, up by 7 per cent and 12 per cent respectively (in sterling terms, annual averages).

As a result of this reduction in portfolio investment the demand for external funds is expected to decline slightly even though savings are lower. Within this reduced total, bank borrowing falls £1.5bn from the heights of last year to £6.0bn whilst new issues increase marginally to £4.6bn. The small reduction in dependence on bank borrowing occurs because in contrast to 1984-5 interest rates are higher (base rates average 10.7 per cent in 1984-5 and 11.5 per cent in 1985-6). Also the equity market strengthens further this year thus reversing last year's comparative advantage enjoyed by bank loans. We do not expect medium dated bills to become a significant source of funds. These factors result in a significant fall in funds in 1985-6.

Chart 1 illustrates these points for the company sector as a whole with savings exceeding both definitions of investment after the first quarter of 1986. This implies a further build up of liquidity particularly in 1986-7.

Over the medium term we expect profits to be weak but as lower interest rates reduce the cost of servicing debt and corporate tax payments fall, savings growth improves marginally. If we assume a fall in demand for investment finance and a greater reliance on internal funds, bank borrowing and equity issues are noticeably reduced. Low profits and the continuation of the government's privatisation programme are expected to weaken the equity market and discourage equity finance from next year. This factor might account for the present buoyancy of new issues as we are in the lull between British Telecom and British Gas.

The issues resolved

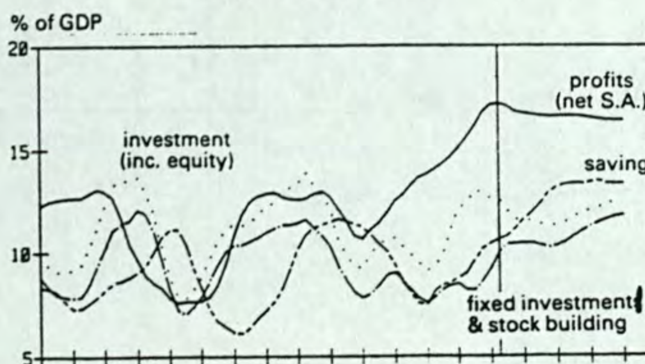
The relationship between profits and fixed capital formation which appeared to break down in 1983 should really be analysed in terms of savings and a broader measure of investment. By allowing for this we can put a more optimistic interpretation on current behaviour but a large gap between savings and investment is still expected to emerge over the next four years. Investment weakens and liquidity builds up. The impact of this is reflected by a fall in bank borrowing and new equity issues, the latter falling sharply as the equity market loses the strength of recent years.

Sources and uses of funds: Industrial and Commercial companies

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
SAVING AND CAPITAL TRANSFERS											
Saving	217.8	23.3	22.9	23.9	26.5	30.8	31.1	29.6	29.8	99.7	535.4
Net Capital Transfers	—	0.3	0.6	1.6	1.2	0.7	0.7	0.8	0.8	—	—
INCREASE IN BORROWING											
Bank Borrowing (excluding house loans)	14.9	4.3	4.7	4.3	4.5	5.8	5.0	5.2	5.4	1.7	56.1
House Purchase Loans Total	54.3	10.4	15.1	14.7	16.8	16.4	17.1	17.3	17.2	0.0	179.4
Hire Purchase	4.3	0.0	0.5	0.7	0.5	0.5	0.8	0.5	0.3	-1.7	6.5
Other (net)	-4.8	0.9	2.1	4.3	5.6	5.0	-0.5	-0.9	-0.5	-9.1	4.6
TOTAL SOURCES	286.6	39.3	45.9	49.4	56.4	59.2	54.4	52.5	53.1	83.9	782.1
USES											
INVESTMENT AND STOCKS											
Investment and Stocks	—	10.8	13.6	15.9	16.7	17.9	20.6	22.7	24.8	—	—
ACQUISITION OF FINANCIAL ASSETS											
Notes and Coin	8.0	0.5	1.3	0.1	0.6	0.3	0.5	0.2	0.4	0.0	11.9
Bank Deposits	37.4	3.5	5.6	1.0	4.1	6.8	3.0	4.4	4.5	6.1	75.7
Building Society shares	51.4	7.0	10.3	11.8	12.3	11.8	10.6	9.7	7.3	0.0	132.4
Gilts and other long-term public debt	15.0	1.6	0.6	1.9	3.3	1.2	1.4	-0.3	-0.3	4.5	29.0
UK Debenture, Ordinary and Pref. Share	42.3	-2.5	-3.2	-3.3	-2.5	-2.2	-2.7	-4.4	-4.8	75.2	91.9
Net Foreign Currency assets	4.5	0.2	-0.1	1.4	1.6	2.0	0.2	-1.2	-1.5	4.0	11.2
Unit Trust Units	3.3	0.1	0.2	0.8	0.5	0.8	0.8	0.8	0.8	6.7	14.9
Nat. Saving Certificates	8.7	3.6	1.2	1.3	1.7	1.0	0.7	0.3	0.2	0.0	18.7
Other National Savings	6.5	0.6	1.8	2.0	1.4	1.6	1.0	1.0	1.1	0.0	17.0
Trade Credit (net)	2.1	0.0	0.8	1.3	1.3	0.2	0.3	0.3	0.2	0.0	6.5
Equity in Pension Funds and Insurance Cos	106.5	13.2	13.6	14.6	16.6	17.2	17.9	18.9	20.4	130.3	369.2
Accruals Adjustment	0.8	0.4	0.1	0.5	0.6	0.6	0.2	0.1	0.1	0.0	3.7
TOTAL USES	286.6	39.3	45.9	49.4	56.4	59.2	54.4	52.5	53.1	83.9	782.1
MEMORANDUM ITEMS											
Financial balance	217.8	12.7	10.0	9.6	11.1	13.6	11.3	7.6	5.8	236.0	535.4
House Purchase Loans by Sector:											
(a) From Banks	3.1	3.1	4.8	3.9	2.5	3.0	3.4	3.6	3.7	0.6	31.7
(b) From Building Soc's	44.4	5.9	9.6	11.0	14.4	13.2	12.8	12.8	12.9	0.0	137.1
(c) From Other	6.8	1.4	0.6	-0.2	-0.1	0.2	0.9	1.0	0.6	-0.5	10.6

COMPANY SECTOR
PROFITS, SAVINGS & INVESTMENT
(4-qtr. moving average)



Overseas Sector

Major issues

- The overseas sector has been purchasing substantial quantities of gilts this year. Why is this and will it continue?
- Are these purchases being financed through overseas sector transactions with the banks, which implies they will not help to reduce monetary growth, or through transactions with the UK non bank private sector?

Recent developments

Movements in the exchange rate have played an important role in determining the current balance so far this year. In the first half, changes in the volume of exports and imports were small but their valuation (the terms of trade) changed dramatically. This helped the current balance move from deficit to surplus between the first and second quarters, and in the third quarter the loss of competitiveness associated with a strong pound helped to cause a major fall in the volume of exports (both with seasonally adjusted and unadjusted data).

However, the end of the miners' strike led to a large decrease in fuel imports so that despite a fall in crude oil exports (due to extensive North Sea maintenance work) and a depressed sterling price of oil (reflecting weak world oil prices and a rising exchange rate) the oil surplus increased sharply in the second quarter.

Non-oil import volumes have been falling steadily over this year. Exports rose in the first half but are now falling both in value and volume although excluding erratic items the fall in exports is smaller. In the third quarter imports fell in value but rose in volume.

Despite the switch in the current account from deficit to surplus between the first and second quarters, investment and other capital transactions moved from a £2.2bn outflow in the first quarter to a £0.15bn inflow in the second quarter. These apparently conflicting movements on the current and capital accounts were possible for two reasons. First, there was a high balancing item of almost £3bn inwards in the first quarter which became a £0.5bn outflow in the second quarter. In addition total official financing (which includes foreign currency borrowing as well as drawings on reserves) switched from drawings of £2.7bn in the first quarter to additions of £4.4bn in the second quarter.

Within the investment and capital transaction figure the major forces behind the changes between the first and second quarters of this year were UK private investment and UK bank lending overseas. UK investment overseas returned to more normal levels in the second quarter after exceptionally high non-bank investment in the first quarter. Much of the change in UK bank lending overseas (from almost £3bn borrowing to £2½bn lending) reflects a change in the banks' method of foreign borrowing, to the issuance of floating rate notes and bonds which appear as overseas portfolio investment. Overseas investment returned to more normal levels after several major company purchases in the first quarter.

The outlook

We expect the current balance to reach a turning point during the next two years. After improving this year with the rebound from the miners' strike, there is only one more year of surplus during our forecast period. From the middle of 1987 we expect the current balance to move into medium term deficit. This partly reflects the projected fall in North Sea oil production. It is also due to slower growth in net exports stemming from the adverse effect which a higher value of sterling has on UK competitiveness. The fall in export growth can already be seen in the third quarter balance of payments figures and the CBI survey of export order books which shows orders are well below normal.

This year we expect the UK's net acquisition of overseas assets to be almost £5bn. This is despite a forecast of a major increase in foreign purchases of UK gilts and a slowdown in UK purchases of overseas securities. The expected counterparts are a significant change in bank lending to the overseas sector, with a move from net bank borrowing. Though some of this change can be explained by the UK banks' move to using floating rate bond issues to finance foreign borrowing. Also we expect a decrease in overseas purchases of UK equities. In this year's bank deposits figure we expect a dramatic rise in both overseas deposits at UK banks and overseas bank loans with deposits increasing by £5½bn and loans increasing by £9bn.

After this year's major shift in overseas assets and liabilities we expect the flows to become more stable with falls in UK acquisitions of overseas securities, increased deposits by the overseas sector at UK banks and increased purchases of UK equities by foreigners all reflecting the move from current account surplus to current account deficit.

The issues resolved

A combination of the end of overfunding (which will restrict the supply of gilts in the future) and a forecast fall in interest rates in 1986 means that gilts prices can be expected to rise next year. This is reflected in our forecast for the price of gilts which rises by almost 12 per cent this financial year. This means that our forecast increase in gilts holdings by the overseas sector this year reflects an expected capital gain next year. This effect can be seen on Chart 1 which shows a dramatic rise in the purchases of gilts this year which tails off next year when prices are expected to be more stable.

Recent developments

	1984	1985						Forecast
	Q4	Q1	Q2	Q3	July	Aug	Sep	1985/6
Current account, £m s.a.	424	-535	1183	750	344	206	200	4800
Visible trade, £m s.a.	-1313	-1283	-222	-450	-56	-195	-200	-1419
of which:								
oil	1468	1862	2368	2042	693	667	683	n/a
non-oil	-2780	-3145	-2589	-2492	-749	-861	-882	n/a
Investment and other capital transactions, £m, n.s.a.	-868	-2230	147	n/a		n/a		-4800
Official reserves, £m, n.s.a. (drawings on +)	-305	90	-607	n/a		n/a		0

Sources and uses of funds: Overseas sector

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Stock 89Q1
ACQUISITION OF FINANCIAL ASSETS										
Foreign Currency deposits net of loans, at UK banks	-6.0	2.4	1.9	0.5	5.9	-0.5	-0.9	-0.2	0.3	-0.3
Bank deposits net of loan	2.8	0.3	0.5	0.8	1.4	-3.5	0.5	2.3	4.0	8.8
Wholesale Deposits	0.5	-0.1	0.2	0.0	0.1	-0.1	0.2	0.6	0.7	2.1
Overseas Securities & net Direct Investment	-23.1	-5.7	-7.5	-6.2	-9.7	-6.0	-3.6	-2.2	-3.0	-145.3
Net Trade Credit	0.1	0.6	0.2	0.2	0.1	0.0	0.1	0.1	0.1	1.5
Gilts and other long-term public sector debt	6.5	0.2	0.6	1.1	1.5	2.4	0.0	-0.5	-0.6	15.9
UK Debentures, Ordinary and P Share Holdings	8.2	1.2	0.6	1.2	3.4	0.3	0.8	0.9	1.1	33.2
Other assets including balancing item	—	-3.3	-1.8	0.0	-2.0	2.6	0.7	0.2	1.4	—
TOTAL										
Net acquisition of financial assets	-11.1	-4.4	-5.2	-2.5	.6	-4.8	-2.1	1.2	3.9	-84.1

If an expected capital gain were the only cause of the increase we would expect this year's transactions to be followed next year by profit-taking sales of a similar order of magnitude. However, Chart 2 shows that the level of gilt holdings remains high throughout the forecast period. This shows that although this year's exceptional increase has been boosted by expectations of unusual capital gains, there is also a longer term demand from the increased diversification of international financial institutions (particularly Japanese pension funds). This can be seen more clearly if we look at the level of equity holdings whose growth is not restricted by the fall in supply associated with the end of overfunding.

This year we are forecasting that the overseas sector will move from being a net lender to UK banks to being a net borrower. This suggests that the increase in gilts purchases by the overseas sector that we forecast for this year will be financed by running down sterling deposits and not by sales of securities to the UK non-bank private sector.

F.B.

Chart 1

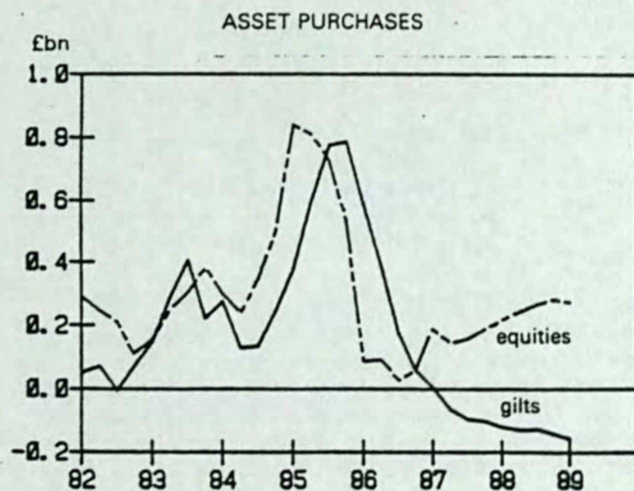
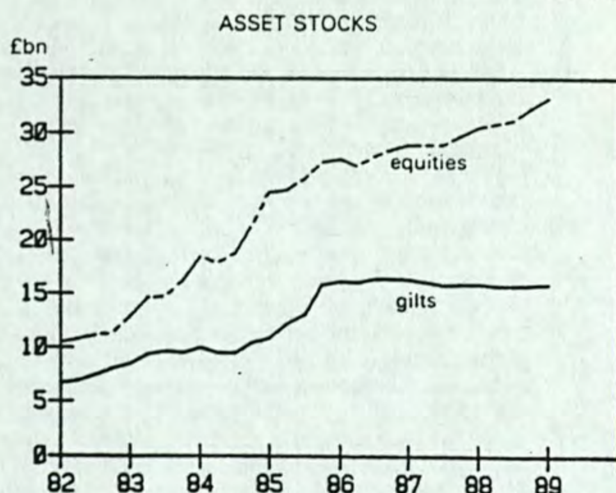


Chart 2



Monetary Sector

Major issues

- Will the banks raise more finance through foreign currency bond issues?
- Will it be possible for the banks to maintain the net inflow of significant sterling sums from abroad given that the overseas sector needs finance for its gilts purchases?

Recent developments

In the financial year to April this year the monetary sector received net inflows of sterling deposits from the overseas sector of £3.6bn. A large net contribution to maintaining the growth of sterling lending to the UK private sector has been forecast since the first issue of *Financial Outlook*. However, during the current financial year these net inflows have been reversed in order to finance large purchases of gilts by the overseas sector. The banks have been issuing large amounts of floating rate debt which has served to replace the net deposit position of the overseas sector in the balance sheet of the monetary sector.

High interest accounts have continued to attract funds into the banks from the personal sector. The relative return compared with Building Society accounts, highlighted in our last *Outlook*, has settled down to a less competitive level. Cuts in base rates over recent months have increased the advantage of Building Society accounts; for example, instant access higher interest accounts with balances of £5000 yield 9.5 per cent CAR net at large Building Societies in October against 8.35 per cent at banks. Company sector deposits have been weak, but this has been offset by continued growth in sterling deposits of other financial institutions, especially Building Societies. Overall, sterling deposits by the UK private sector have been rising at £2bn per month for the last two months. Deposits to clearing banks rose by £713 million in banking September.

Lending to the UK private sector has followed an irregular path this year. Borrowing by industry was concentrated in the first three months in order for firms to take advantage of the higher rate of capital allowances on investment. Much of this lending was channelled through leasing companies where lending rose by £1.1bn (24 per cent). Since then lending to manufacturing has grown less rapidly, 2 per cent in the 3 months to mid-August. Within the total, electrical engineering has borrowed more and chemical and food, drink and tobacco industries less. Lending to persons has weakened since April as highlighted in the last *Financial Outlook*, although the August figure was above this declining trend. In the three months to mid-August lending for house purchase rose £1.3bn (+7 per cent) and other advances £1bn (+5 per cent). Within this figure lending to unincorporated businesses has been strong. Figures from the clearing banks for September suggest further strength in lending for house purchase, up £234m and lower growth in other personal borrowing, up only £75m of which much was credit card borrowing. The banks' share of total loans for house purchase fell from 26 per cent to 15 per cent in 1984/5 and a rebuilding of share now appears to be taking place.

Figures for sterling lending to the UK private sector for 1984-5 are difficult to relate to earlier years due to a change in the operations of the Bank of England. Overfunding during 1985 first quarter took place through the banking department of the Bank of England. The sums involved appear as an increase in £ lending to UK private sector and a reduction in £ lending to the public sector as the banking department is considered to be part of the monetary sector. In 1984-5 we estimate using figures for public sector deposits into the banking department, that £6.5bn of the total sterling lending to the UK private sector was involved in the overfunding operation. In the forecast we assume that the banking department retains its current amount of bills and that any further degree of overfunding takes place through issue department operations as was previously the case.

The outlook

Recent sales of gilts to foreigners by the authorities has altered the net position of the overseas sector with the monetary sector. In order to finance those gilt purchases, overseas institutions have run down their sterling deposits in the UK. It seems that they have been doing this during the current financial year in the expectation of a sharp rise in the price of gilts. The net contribution from overseas to monetary sector deposits will therefore be −£3.5bn in the current financial year compared with a figure of +£3.6bn in the year to April 1985. After this year we expect the net position to be positive but not significant.

Non deposit liabilities in foreign currency have been growing significantly recently, as an alternative source of funds to sterling deposits by the overseas sector. Large amounts of floating rate debt in foreign currencies has been issued. The relative size of the contribution of these non deposit liabilities is shown in the chart. With further expected growth in sterling net inflows we forecast that the current level of new lending to the UK private sector can be maintained despite the slowdown of funds. The net position of the overseas sector is expected to return to approximate equality and then to making a further net contribution to the liabilities of the sector. The decline in the sterling UK private sector deposit base highlighted in previous issues of *Financial Outlook* continues to be part of the current forecast. The share in total liabilities of these deposits is expected to fall below 40 per cent by the end of the forecast period from 45 per cent this year and 60 per cent in 1981-82. The maintenance of current levels of new lending therefore requires contributions from outside the traditional source of liabilities.

The importance of these liabilities for the sector is shown in the chart. When combined with some growth in holdings of sterling non deposit liabilities current sterling deposit growth is sufficient to meet the demand for sterling lending by the UK private sector. Following the reduction in growth of lending to the overseas sector next year we forecast that non deposit liabilities will fall back to 1983 levels as banks reduce lending in foreign currency to all sectors and in sterling to the overseas sector. The return to a net positive contribution of the overseas to the monetary sector is required to offset the fall in deposits by the UK private sector later in the forecast in maintaining a more stable level of sterling lending to the UK private sector.

NON-DEPOSIT LIABILITIES AS A
PERCENT OF UK STERLING DEPOSITS

The issues resolved

The steep increase in sterling deposits from the UK private sector in 1984-5 has been supplemented by further issues of foreign currency bonds as a source of finance for new lending. The uncertainty attached to net sterling deposits from overseas has been highlighted by the recent net withdrawals to finance gilt purchases by the overseas sector. We expect a continuing need for source of finance for the monetary sector in the face of declining deposits in the future.

P.N.S.

Monetary sector liabilities and assets

£ billion

	Stock	Actual				Forecast				Stock
	81Q1	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9	89Q1
LENDING										
£ Lending to UK private sector	54.7	10.7	15.8	12.1	21.2	15.5	15.6	14.7	14.2	178.6
Lending in £ to overseas	9.1	3.4	3.6	3.9	5.5	5.9	1.7	–0.1	–1.4	32.4
Lending in £ to public sector	16.6	0.1	–3.3	–0.9	–4.4	–0.7	–0.7	–0.4	–0.3	15.4
Net f.c. loans to all sectors (excl non-deposit liabilities	1.2	0.5	0.2	1.8	6.2	1.9	0.3	0.8	0.6	11.5
TOTAL lending	81.6	14.8	16.2	16.9	28.4	22.6	17.0	15.0	13.1	237.6
Financial balance	–0.8	1.3	1.7	2.2	2.2	2.4	2.6	2.4	3.1	27.6
Equity and deb. issues	13.9	0.0	0.4	0.4	0.4	0.2	0.2	0.2	0.2	17.5
Purchases of equity & debs	–2.2	0.1	0.1	–0.7	2.0	0.0	0.0	0.0	0.0	–3.5
Foreign currency non-deposit liabilities	0.2	0.3	0.5	2.4	4.6	4.5	0.5	0.5	0.5	7.2
Other sterling non-deposit liabilities	0.0	0.1	–0.3	0.4	–1.8	2.0	0.7	1.4	1.5	5.6
UK private sector sterling deposits	57.3	9.2	8.9	7.5	11.6	10.8	10.6	8.1	5.0	136.6
Overseas Sterling deposits	11.8	3.7	4.5	4.2	9.1	2.4	2.2	2.2	2.6	43.5
Public sector deposits	1.4	0.2	0.3	0.3	0.4	0.3	0.1	0.1	0.1	3.3
TOTAL	81.6	14.9	16.1	16.8	28.4	22.7	17.0	15.0	13.1	237.8
Of which: non-deposit liabilities:										
in sterling	—	1.5	1.9	2.3	2.7	4.6	3.6	4.0	4.9	—
in foreign currency	—	0.3	0.5	2.4	4.6	4.5	0.5	0.5	0.5	—
total	10.9	1.7	2.4	4.7	7.3	9.1	4.1	4.5	5.4	47.2

Recent developments

	1984		1985		1985					
£ million, unadjusted	**Q3**	**Q4**	**Q1**	**Q2**	**April**	**May**	**June**	**July**	**Aug**	**Sep**
UK private sector £ bank deposits	2328	3936	1637	3897	4258	239	2970	–342	2080	1963
Overseas £ bank deposits	1707	951	4305	–398	354	–220	–263	421	291	–15
UK private sector £ lending (exc. BoE bills)	1796	4178	9730	4584	1932	676	293	4294	76	508
Overseas £ lending	1399	1651	890	–383	657	249	36	–499	–648	197
Memorandum item: UK private sector £ lending (including BoE bills)	3818	4943	7121	4441	2832	873	752	3104	1115	421

Building Societies

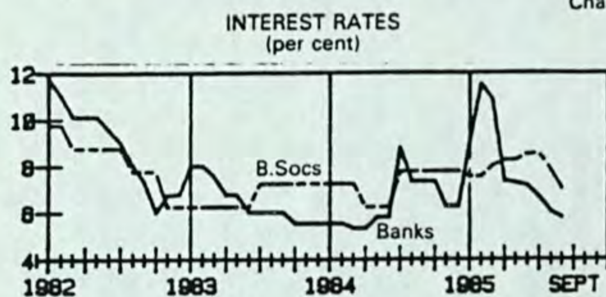
Major issues

Total savings by the private sector are running at high levels at present. However, the banks are mounting a major bid to increase their share of the market, by offering more competitive rates of interest on instant-access accounts. Why are the banks behaving in this way? Will the Building Societies gain more from the increase in total savings than they lose from increased competition with banks? And how will they respond to the increasing inroads that the banks are once again making into the personal mortgage market?

Recent developments

Chart 1 shows recent movements in bank and Building Society deposit rates. At the beginning of the year the sharp rise in short-term interest rates made banks highly competitive relative to Building Societies. As Building Societies have adjusted to the new level of rates – which have in any case declined in the course of the year – this competitive advantage has been eroded if not reversed and inflows have recovered from the low levels recorded between February and April. However, more recent figures suggest that the Building Societies are continuing to lose market share in the face of increased competition from the banks. The reason is not easy to discern in the official statistics, which show that the return on ordinary shares is competitive with that on conventional seven-day bank deposits. But these statistics do not reflect the attractiveness of the banks' newer savings accounts offering high rates of interest to large depositors. Although the Building Societies have responded by offering other improvements in rates and facilities, the evidence suggests that the banks' drive to arrest their loss of market share by matching the Building Societies' terms is bearing fruit.

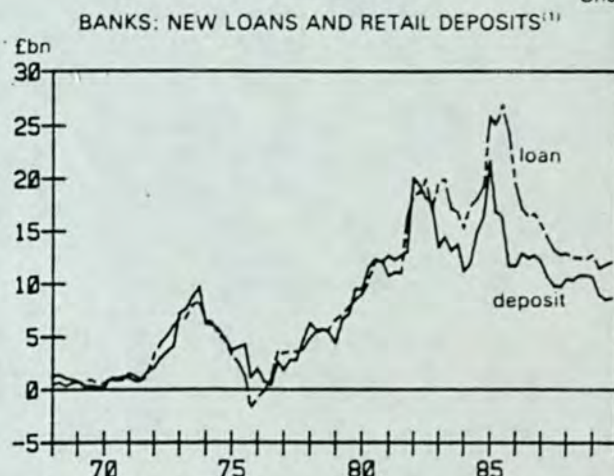
Chart 1



The background

The banks' drive for additional retail deposits – triggered off by the switch to the new composite rate earlier in the year – has been accelerated by the authorities' new financial policy. This is to sell enough gilts to fund the PSBR, rather than overfunding it in order to bring sterling M3 within target. The previous policy of overfunding left the authorities with substantial proceeds from their excess gilts sales. At the same time bank loans were growing rapidly, and outstripped the growth of deposits, as Chart 2 shows. This shortfall was made good by the issue of commercial bills which were taken up by the Bank of England. In this way the excess liquidity in the public sector (resulting from overfunding) was channelled back into the private sector. The whole operation tended to drive up long rates (in order to sell the gilts) and hold short term rates lower than would otherwise have been needed to keep the demand for bank loans in line with available deposits.

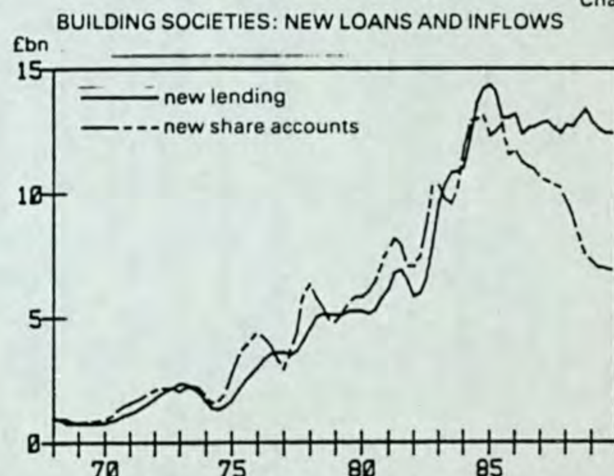
Chart 2



[1] incl. notes and coin.

Now that overfunding has ceased – it actually stopped in the summer, but official confirmation of this fact only came in the Mansion House speech – fewer gilts will be sold, permitting long term interest rates to fall. But without the cushion of corresponding bill purchases, bank loans and deposits will have to be brought in line. This inevitably means higher deposit rates to boost inflows and higher loan rates to choke off loan demand.

Chart 3



The large and growing gap between retail deposits and loans, which was encouraged by overfunding, was very largely a banking phenomenon. Chart 3 shows that the Building Societies kept their inflows broadly in line with deposits. This means that the end of overfunding will largely require adjustment by the banks. The need to raise deposits to meet loan demand, now that the gap can no longer be cheaply plugged by selling commer-

Recent developments

£ million	1984 Q4	1985 Q1	Q2	Q3	1985 June	July	Aug	Sept
Net increase in shares & deposits outstanding	4188	2573	3272	2923	1597	1377	609	937
Mortgages								
new commitments	5657	6010	6833	6931	2209	2236	2171	2490
net advances	3402	3090	3658	3471	1208	1237	1161	1073
Liquidity ratio, percent	18.3	16.5	16.5	17.0	16.3	16.7	16.8	17.0

Sources and uses of funds: Building Societies

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
Financial balance	7.6	0.2	–0.2	0.6	0.4	0.9	1.0	0.9	1.2	2.6	15.1
Building Society Shares	51.4	7.0	10.3	11.8	12.3	11.8	10.6	9.7	7.6	0.0	132.4
Wholesale funds incl CDs	0.3	0.1	0.2	1.8	1.0	1.8	1.3	1.2	2.2	0.0	8.9
Other	–0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–0.5
Accruals Adjustment	1.1	0.2	–0.2	0.3	0.2	0.1	0.7	0.0	0.0	0.0	1.1
TOTAL SOURCES	60.0	7.5	10.2	14.5	14.0	14.6	12.1	11.8	9.6	2.6	157.0
USES											
Notes & Coin and bank deposits incl CDs	1.7	0.6	0.2	1.7	–0.3	1.8	0.3	0.1	–0.5	0.0	4.6
Treasury & LA bills	1.3	0.0	–0.5	0.1	–0.1	–0.7	0.0	–0.2	–0.7	0.0	0.1
Gilts	12.6	1.1	0.9	1.7	0.0	–1.2	–1.0	–0.8	–0.8	2.6	15.2
House Purchase Loans	44.4	5.9	9.6	11.0	14.4	13.2	12.8	12.8	12.9	0.0	137.1
TOTAL USES	60.0	7.5	10.2	14.5	14.0	14.6	12.1	11.8	9.6	2.6	157.0

cial bills to the authorities, helps to explain the banks' recent display of aggression in the retail deposit market.

The outlook

Sources

The change of policy means that short-term interest rates will be higher than we previously predicted, and we expect the adjustment to be borne largely by the banks, for the reasons given above. This means that bank deposit rates will be higher, and we expect a corresponding reduction (both absolute and compared with our July forecast) of Building Society deposits from 1986-7 onwards. We also expect Building Societies to raise slightly less money in the wholesale markets over the forecast period. This is also a consequence of higher interest rates and increased competition from banks, though in the later years it partly reflects the weaker financial position of companies which means that they have less cash to lend on the wholesale money markets.

Uses

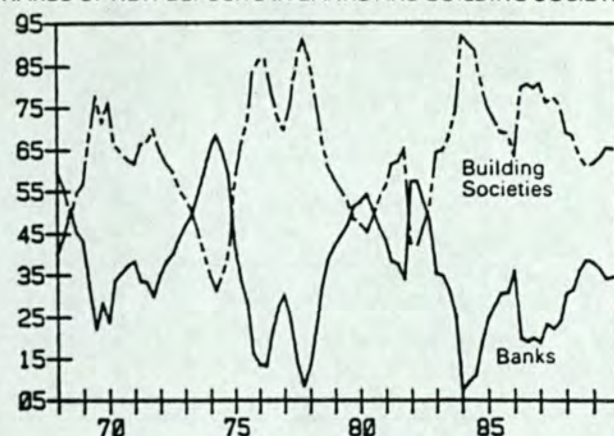
On the uses side of the account we expect mortgage lending this year to be slightly below last year's record levels. This is because the increase in interest rates earlier this year pushed up mortgage rates and reduced demand. Although interest rates are coming down over the forecast period, allowing mortgage rates to fall also, we expect a reduced level of mortgage lending by Building Societies next year compared with this because of increased competition from banks in this important sector of the market. The cutback in mortgage lending next year is not however expected to be as great as the reduction in inflows (which amounts to some £1 ¾bn taking retail and wholesale funds together). The difference is made up by liquid assets: after a forecast build-up of £1.8bn this year we expect little further addition to liquid reserves in the following two years. Looking further ahead the model suggests a reduction in liquid assets might be needed by the end of the period in order to maintain new mortgage lending at around £13bn p.a.

The issues resolved

We see the Building Societies entering a rather difficult period, with the banks showing a new determination to recapture lost ground in the personal savings market. Because bank deposits have until very recently been a rather unattractive savings medium, Building Societies have been able to establish a large competitive advantage. Banks have tolerated losing ground to the Building Societies in the competition for personal retail deposits because they have nevertheless been able to maintain their flow of lending. This they did by tapping the supply of short term funds available from the public sector as a consequence of the policy of overfunding. With that source of funds now removed the banks are being forced to compete even more aggressively for retail funds, and the Building Societies are inevitably in the front line of this attack. We expect the Building Societies to lose market share (from a very high level, as Chart 4 shows), but not to the extent of having to cut back new mortgage lending very significantly from next year onwards. P.W.R.

Chart 4

SHARES OF NEW DEPOSITS IN BANKS AND BUILDING SOCIETIES



Pension funds and insurance companies

Major issues

- How will the pension funds and insurance companies react to the end of overfunding? The implication of the Chancellor's Mansion House Speech, in which he announced a policy of exactly funding the PSBR, is that the flow of new gilts will be much reduced. Will the institutions accept this passively and switch into equities or will they maintain their gilts purchases by acquiring gilts from other sectors?
- Initial figures for 1985-6 show that pension funds and long-term insurance companies (though not the general funds) have started to run down the liquidity built up last year. Will this continue? What form will a liquidity rundown take over the next few years?

Recent developments

Total inflows into the combined funds in the 1984-5 financial year reached £16.6bn, an increase of 13½ per cent on the previous year. This reflects strong growth in wages and salaries and in dividend and interest earnings. Additionally, first quarter receipts were boosted by pre-Budget inflows. In the second quarter receipts dropped back, though the underlying inflows remained strong. Reflecting two years in which receipts of the combined funds have risen by nearly one quarter, assets are now well in excess of liabilities which have fallen following large-scale redundancies and the reduction in employment since 1980. Consequently, many companies are looking for ways of reducing or eliminating the over-valuation of their pension funds. The Inland Revenue expects surpluses to be reduced as quickly as possible, since they represent over-provision of tax relief to schemes. However, the Revenue's approach appears to vary greatly from one company to another. Gomme Holdings were hoping to claw back £2.9 million from its fund out of a total surplus of £4.1 million in order to finance other activities. The Inland Revenue prevented this, suggesting instead that the surplus be reduced either by improving benefits or by giving contribution holidays to both employees and employers. By contrast, Redfearn is to be allowed to withdraw £1.7 million from its fund, apparently because its overall financial position is less satisfactory.

For much of the last two years gilts have been the main beneficiary of the high volume of inflows. This largely st[illegible] from the government's policy of overfunding, now officially abandoned. Thus in 1984-5 pension funds and insurance companies combined purchased £5.3bn of long-term public sector debt, little changed from the 1983-4 outturn. In the first quarter of the current financial year, the change in policy (which dates from mid-May) is evident in the provisional figure for pension funds which shows a drop in purchases of public sector securities to £0.7bn from £1.1bn in the first quarter. (For insurance companies however, there was an increase from £500 million to £650 million.) Figures for the July-September quarter and beyond are likely to show a further reduction in gilts purchases.

The major counterparts to gilts in the funds' portfolios over recent years have been UK company and overseas securities. The latter were built up rapidly in the early 1980s following the abolition of exchange controls in 1979 but by 1984 the stock adjustment appears to be over. UK equities, which were run down in 1983-4, have been re-built over the last year, partly because of the purchase of shares in British Telecom and also because of institutional take-up of new issues made by companies on a buoyant equity market.

Of the other assets in the portfolios of the combined funds, the most notable development has been the build-up of liquid assets. Partly this represents the need to build up bank deposits and other liquid assets ahead of major calls on the funds (such as the coming call from Telecom), but it also indicates the rapid increase in fund receipts and the uncertainty associated with overfunding.

If we consider pension funds and life assurance companies separately, we note that the former purchased over £1bn of equities in 1984Q4 and again in 1985Q2, in each case associated with the BT flotation. Pension funds were also strong purchasers of overseas securities again in the first half of 1985, when £1.2bn of assets were acquired (more than double the full 1984 outturn of £470 million). For insurance companies the main destination for funds has been the UK equity market. Net investment rose from £1.9bn in 1983 to £2.5bn last year and £3.5bn at an annual rate in the first half of this year.

The outlook

Total inflows into the combined funds are expected to rise less rapidly in 1985-6 and beyond than in the last two years. This reflects a lower rate of increase in wages and salaries and weaker investment earnings. This in turn is due to falling interest rates (base rates are forecast to fall to 9 per cent by the end of 1986 and long rates average 8½ per cent throughout next year) and a weaker outlook for profits and hence dividends. Addi-

Recent developments

	1984				1985	
	Q1	Q2	Q3	Q4	Q1	Q2
	£ million					
Investment in:						
UK equities* –						
pension funds	618	582	633	1004	643	1346
insurance companies	387	473	491	308	515	662
Gilts –						
pension funds	715	369	516	595	1111	702
insurance companies	378	703	453	877	491	660
Overseas securities –						
pension funds	31	−143	299	283	825	423
insurance companies	448	132	137	−7	279	125
Short-term assets –						
pension funds	445	799	398	36	37	−267
insurance companies	448	295	396	707	142	−419

* not including holdings of unit trusts or Local Authority Mutual Investment Trusts.

Sources and uses of funds: Pension funds and insurance companies

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Stock 89Q1
SOURCES										
Bank Loans	0.2	0.1	0.4	0.4	1.0	0.1	0.1	0.1	0.1	2.5
Insurance co. equity and deb. issues	11.8	0.1	0.0	0.0	0.3	0.0	0.0	0.0	0.0	20.7
Net inflow into Pension Funds and Insurance Co's	106.5	13.2	13.6	14.6	16.6	17.2	17.9	18.9	20.4	369.2
TOTAL SOURCES	118.5	13.4	13.9	15.1	17.9	17.3	18.0	19.0	20.5	392.4
USES										
Bank Deposits	2.7	1.2	1.0	1.9	2.3	0.1	1.7	0.6	0.0	12.0
Gilts	30.8	4.3	3.2	5.2	5.3	4.1	6.1	7.8	7.8	97.7
UK Debenture, Ordinary and Pref Share Holdings	47.8	3.2	3.4	2.5	4.4	6.3	5.9	7.5	7.6	171.8
Foreign Currency Shorts	0.1	0.1	0.0	0.2	0.2	0.0	0.0	0.1	0.1	1.1
Treas. & LA Bills, B. Soc CDs	0.7	0.2	0.2	0.4	0.5	1.2	0.6	0.1	1.3	5.1
Overseas Securities	7.9	2.9	3.6	2.3	1.7	2.5	1.0	0.3	1.5	49.4
House Purchase Loans	2.1	0.1	0.0	0.2	0.2	0.5	1.1	1.0	0.6	5.7
Property and other assets	26.3	1.4	2.5	2.5	3.4	2.6	1.6	1.8	1.6	49.5
TOTAL USES	118.5	13.4	13.9	15.1	17.9	17.3	18.0	19.0	20.5	392.4

tionally the funds themselves are acting to reduce their surpluses. Total net inflows are projected at £11.2bn this year (3.7 per cent up on 1984/5) and £17.9bn in 1986-7 (+4.2 per cent).

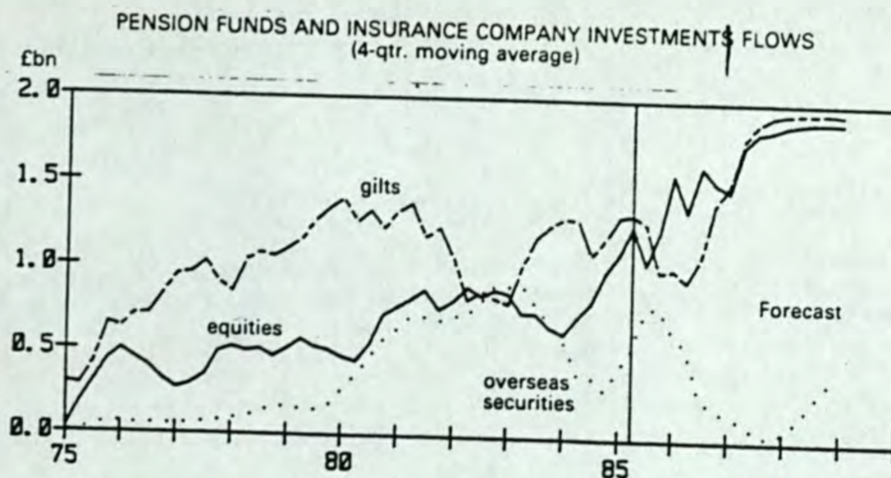
The change in official policy on overfunding implies much lower gilts sales and we assume that they average £6bn p.a. from now on. We expect the pension funds and insurance companies to respond to this policy initiative in the short term by moving into equities and other corporate debt. In 1986-7 and, especially, in 1987-8 and beyond the funds are forecast to wish to maintain their gilts purchases and to do so by buying long-term government securities from other sectors (chiefly Building Societies). Thus in 1985-6 we expect total gilts purchases to be only £4.1bn which is £1bn less than in 1984-5 and over £4bn below our July projection which assumed continued overfunding. The main counterpart to this is on the equity side where we now project £6.3bn of purchases (compared with only £3.7bn in July). Beyond this year equity investment remains strong and inflows to gilts strengthen. The principal offsets to this are in the property and other (unidentified) assets row, which is a weak element over the forecast period, and also in the overseas purchases row. The stock-adjustment process is now, we judge, complete and, as the pound is slightly weaker over the next two years, investment overseas is more expensive. Beyond this financial year purchases of overseas securities remain modest.

The issues resolved

We expect pension funds and insurance companies to respond to the changed policy regime by buying fewer long-term government securities this year. Equities are the main destination of the funds released in this way. In later years the combined funds are expected to wish to purchase more gilts than will be on offer and these will be acquired from other sectors. This implies a more buoyant gilts price than we forecast in July and a lower long-term interest rate.

At the present time the funds are extremely liquid, though the pension funds and long-term insurance companies have started to run down the liquidity built up last year. We expect this process to continue over the next 12 months as some liquid assets are transferred into longer-term investments and as the flow of new receipts slows down.

GRD



Unit and Investment Trusts

Major issues

- The steady increase in the flow of funds into Unit Trusts evident since 1980 is continuing, with 1985 promising to be a record year for both gross and net sales. Is this largely due to market entry by insurance companies and will the expansion continue?
- Will this increased flow of funds be invested abroad, continuing the trend since the removal of exchange controls in 1979?

Recent developments

Total net sales of Unit Trust units have risen sharply in 1985 with the figure for the third quarter, £618 million, more than doubling the amount for the third quarter of 1984. This continues the rapid expansion of Unit Trusts apparent since 1981-2 and reflects both internal growth and the launching of new trusts. Factors which lie behind this growth include first, the high rate of return (net of tax) compared with alternative uses such as Building Society deposits and second, the personal sector's increased gross liquidity. A factor operating against Unit and Investment Trusts in 1984-5 was the attraction of British Telecom sales which may well have been the cause of the slight dip in the expansionary trend for that year.

On the investment side, investment abroad fell sharply in 1984-5 to £0.2bn compared with £1.1bn in 1982-3 and £0.9bn in 1983-4 respectively. It is evident that the low exchange rate in the last six months of 1984-5 discouraged investment overseas and made possible large capital gains on the sale of existing overseas securities. The latter was particularly apparent for Investment Trusts who were net sellers of overseas securities for each of the last three quarters of 1984-5.

The outlook

Despite the vast increase in the size of the Unit Trust industry it still represents a small proportion of the savings of the personal sector. Market entry by a number of large insurance companies appealing to the middle income group should ensure expansion continues and we forecast net personal sector flows into Unit and Investment trusts to rise to around £0.8bn in 1986-7 and stay at that level. The emergence of new products such as the "fund of funds", a new Unit Trust which invests in other Unit Trusts, should strengthen this trend possibly at the expense of Building Societies.

We forecast that purchases of overseas securities will recover to £0.9bn in 1985-6, around the level of 1982-3 and 1983-4, and stay around that level over the subsequent three years. The portfolio choice between bank deposits, gilts, UK equities and overseas equities is expected to remain very stable in those years. As in 1982-3 and 1983-4, there will be some hedging in the form of borrowing in foreign currency to finance overseas investment.

P.L.L.

Recent developments

£ million

	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1985 Q3	July	Aug	Sept	Forecasts 85/86	Forecasts 86/87
Net sales of Unit Trust* units to the private sector	73	122	211	200**	200**		n.a.		800	800
Other net sales of Unit Trust units	144	244	300	215**	418**		n.a.			
Total net sales of Unit Trust units	247	366	511	415	618	172	185	361		
Investment Trust Equity Issues	50	32	48	55	n.a.	–2	0	n.a.	55	0
Investment:										
UK equities –										
Unit Trusts	138	191	169	310	148**		n.a.		548	562
Investment Trusts	–26	–53	6	57						
Gilts –										
Unit Trusts	14	19	21	2	39**		n.a.		155	154
Investment Trusts	7	30	11	–9						
Overseas Securities –										
Unit Trusts	215	61	348	152	215**		n.a.		966	1024
Investment Trusts	–11	–23	133	–74						

* excluding property unit trusts.
** LBS forecast.

Finance houses and remaining OFIs

This is a small sector including those finance houses and secondary banks that are not contained within the monetary sector, and certain other institutions. However, in computing the data this sector is in some cases treated as a residual. As a result the figures shown here can be misleading and are included mainly for completeness.

Sources and uses of funds: Unit and Investment Trusts

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	Change in base or asset prices	Stock 89Q1	
SOURCES											
Financial balance and sales of unit trust units to OFIs	1.3	0.2	0.8	0.5	0.6	0.8	0.8	0.8	0.8	2.5	9.7
Bank Loans	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Unit Trust Units sold to the personal sector	3.3	0.1	0.2	0.8	0.5	0.8	0.8	0.8	0.8	6.7	14.9
Investment Trust Equity Issues	5.3	0.0	0.0	0.1	0.2	0.0	0.0	0.0	0.0	14.4	20.0
TOTAL SOURCES	10.0	0.4	1.1	1.4	1.3	1.6	1.6	1.7	1.6	23.6	44.8
USES											
Bank Deposits	0.1	0.1	0.0	0.5	0.6	0.2	0.3	0.3	0.4	0.0	2.6
Gilts	0.4	0.0	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.0	1.4
UK Debenture, Ordinary and Pref. Share Holdings	8.2	−0.3	−0.2	0.2	0.4	0.5	0.6	0.6	0.6	10.4	21.0
Foreign Currency short-term assets	−0.1	0.0	−0.1	−0.4	0.0	−0.2	−0.3	−0.3	−0.3	0.1	−1.5
Overseas Securities	1.4	0.5	1.1	0.9	0.2	0.9	0.8	0.9	0.7	13.1	21.3
TOTAL USES	10.0	0.4	1.1	1.4	1.3	1.6	1.6	1.7	1.6	23.6	44.8

Sources and uses of funds: Finance Houses and remaining OFIs

£ billion

	Stock 82Q1	Actual 1982/3	1983/4	~~Estimate~~ 1984/5	1985/6	Forecast 1986/7	1987/8	Stock 88Q1
USES								
Bank Deposits	3.3	0.9	−0.3	−0.1	0.2	0.2	0.2	4.4
Hire purchase etc. loans	1.7	0.4	0.9	0.2	0.4	0.3	0.3	4.2
Foreign Currency short-term assets	−3.8	0.1	−1.1	−1.8	0.0	0.0	0.0	−11.1
Overseas Securities	7.7	−0.2	−0.3	−0.3	0.0	0.0	0.0	16.8
Accruals adjustments	−0.5	0.0	−0.1	−0.5	−0.1	−0.1	−0.1	−1.3
Other assets incl. unidentified	1.7	0.8	3.1	6.0	3.0	1.9	1.1	22.1
TOTAL USES	10.0	2.0	2.3	3.4	3.6	2.4	1.5	35.0
SOURCES								
Bank Loans	10.0	2.0	2.3	3.4	3.6	2.4	1.5	5.0

Public Sector

Major issues

- What are the implications of the end of overfunding?
- Does the 1985 MTFS provide scope for tax cuts? Will it be possible to increase asset sales in order to finance tax cuts?

Recent developments

Half-way through the current financial year the PSBR has reached £5.6bn. This suggests that the Budget target of £7.1bn will again be exceeded though, because receipts are concentrated in the second half of the year, the overshoot may be modest. The outturn to date reflects a budget deficit (net acquisition of financial assets) which is running at about £10bn p.a., with asset sales (the second tranche of British Telecom and Britoil) offsetting adverse seasonal factors in the first half of the year.

In his speech at the Mansion House on 17 October, the Chancellor announced an end to the policy of overfunding: "we are no longer seeking to control £M3 by systematic overfunding ... The objective of funding policy is to fund the PSBR over the year as a whole: no more, no less." This change in financial policy had already become apparent over the summer months, as the table below shows.

Purchases of central government debt by UK non-bank private sector
(£ million, n.s.a.)

3 months ending	Central government debt	of which Stocks	National savings	Tax instruments
1984 Sept 19	3200	2238	1192	-262
Dec 12	3526	2413	591	806
1985 Mar 20	3680	2972	725	-39
June 19	2311	1353	755	208
Sept 18	1012	362	727	-122

Whereas national savings continues at just over £0.7bn per quarter, in line with the 1985 Budget statement, sales of marketable stocks (principally gilts) to UK non banks have fallen sharply in the last four months, although sales to the overseas sector have been buoyant. In the year to mid-May marketable stocks accounted for £9.3bn of central government funding, i.e. 70 per cent of a total for the non-bank private sector of £13.4bn and more than the total central government borrowing requirement (£8.7bn) over the same period. By contrast in the subsequent four months sales of marketable stocks have totalled only £362 million out of total funding of £1.2bn and a CGBR of £5.5bn.

The outlook

We forecast that the PSBR will reach £7.9bn in the current financial year, an overshoot compared with the official target of about £7¼bn. This occurs in spite of more buoyant non-oil tax revenues than in the Budget forecast and in spite of the large contingency reserve (partly taken up by public spending exceeding the official planning total). The main cause of the overshoot is oil revenues, which in the Budget were projected at £13½bn (on the basis of £1=\$1.10-\$1.15) and which we now expect to total only £10½bn (on the basis of £1=\$1.36 on average this financial year). In 1986-7 and beyond we assume the PSBR will be held close to current MTFS targets, i.e. £7bn-£7½bn p.a.

As in July, we have reached the conclusion that if the Chancellor is to stick to his current borrowing targets in 1986-7 and beyond, tax cuts will only be possible if public spending is more tightly controlled than seems likely or if the privatisation programme is stepped up. In this forecast we have modified our approach by assuming £1bn of tax cuts balanced by extra asset sales each year (row 2 of the table opposite). Thus asset sales next year are projected at £3½bn, followed by £3¼bn in 1987-8 and £3bn p.a. thereafter, compared with the illustrative MTFS numbers of £2bn p.a. from 1986-7 onwards. The implication of stepping up the programme in this way is probably that British Gas will have to be fully sold off over the next two to three years, and the Chancellor indicated at the end of October that some of the remaining shares in British Telecom will also be sold.

Of the other items (shown above the middle line) which reduce or add to the PSBR rather than finance it, house purchase loans are expected to be a net benefit to public sector finances this year and next. This means that existing loans will be repaid in part or remortgaged to the private sector. The accruals item is also expected to reduce the PSBR both in 1985-6 and in 1986-7. In the current year this is because the banks are having to pay the composite rate tax on interest paid to individuals on a quarterly basis and next year there is a similar effect as Building Societies move to paying tax on a quarterly basis instead of annually in arrears. For 1987-8 no change has been announced that would offset the underlying adverse accruals effect of about £0.3bn p.a.

The issues resolved

In line with the Mansion House speech we have reduced the volume of gilt sales to £6bn p.a. and national savings to £2.6bn this year falling to around £1½bn p.a. in later years. This means that the sale of public sector debt to the non-bank private sector is in line with the PSBR which remains close to £7½bn throughout.

Additionally we have raised our forecast for asset sales in order that tax cuts can be made in next year's Budget. It should be noted, however, that by raising personal allowances in real terms in 1986-7 – an increase which we assume is not reversed – tax revenues are permanently reduced and this requires higher asset sales not only in 1986-7 but in all future years.

G.R.D.

Recent developments

	1984 Q4	1985 Q1	1985 Q2	1985 Q3	1985 June	1985 July	1985 Aug	1985 Sept
PSBR £bn, n.s.a.	2.9	-0.0	2.6	3.0	-0.1	0.6	1.1	1.3
Revenue annual percentage change	14.6	11.1	7.5	14.5	1.4	25.2	12.7	4.4
Expenditure annual percentage change	10.2	8.2	6.0	8.7	4.9	7.7	6.7	11.9
Gilt sales £bn	2.4	3.0	1.4	0.4	0.0	0.0	0.1	0.3
National savings £bn, n.s.a.	0.6	0.7	0.8	0.7	0.3	0.2	0.3	0.2

Revenue and expenditure are Consolidated Fund figures. Gilts and National Savings figures are in banking months and gilts data refer to marketable debt (stocks)

Sources and uses of funds: Public sector

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Forecast 1985/6	1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
Financial balance	102.1	5.9	9.1	11.8	13.1	10.5	11.6	10.1	9.5	26.5	210.2
UK Debenture, Ordinary and Pref. Share Holding	0.0	0.4	0.1	-1.1	-2.1	-2.5	-3.5	-3.3	-3.0	1.6	-13.3
House purchase loans	4.6	0.8	0.6	-0.4	-0.3	-0.3	-0.2	0.0	0.0	0.0	4.9
Trade credit	-0.8	1.1	-0.4	-0.5	-0.5	0.0	-0.1	0.0	0.0	0.0	-1.2
Other	-12.3	-0.5	-0.5	-0.3	0.8	0.5	0.1	0.3	0.3	9.6	-1.9
Accruals	6.6	0.8	0.0	0.3	-0.6	-0.2	-0.5	0.3	0.3	0.0	7.1
PSBR	100.2	8.6	8.9	9.8	10.5	7.9	7.5	7.4	7.1	37.7	205.7
Bank Deposits	-1.4	-0.2	-0.3	-0.3	-0.4	-0.3	-0.1	-0.1	-0.1	0.0	-3.3
Notes and Coin	11.4	0.1	1.2	0.3	0.9	0.5	0.7	0.5	0.6	0.0	16.1
Gilts and other long-term debt sales to NBPS and overseas	66.7	7.0	5.7	10.7	9.9	6.8	6.9	6.6	6.5	36.1	162.8
National Savings	15.3	4.2	3.0	3.3	3.1	2.6	1.7	1.2	1.3	0.0	35.7
Reserves and other f.c.	-7.1	0.8	1.6	0.2	0.4	0.0	0.0	0.0	0.0	-4.3	-8.4
Issue Department purchases of ICC and overseas (ECGD) bill	-2.8	-4.2	0.3	-3.1	0.1	-2.9	-1.8	-1.3	-1.0	0.0	-16.0
Bill and other debt sales to banks	15.1	0.4	-3.0	-0.9	0.3	-1.0	-0.8	-0.6	-0.4	9.5	18.6
Bill sales to UK NBPS	2.6	0.1	-0.4	0.1	0.2	1.2	0.3	0.0	-0.8	0.0	3.3
Bill sales to overseas	0.5	-0.1	0.2	0.0	0.1	-0.1	0.2	0.6	0.7	0.0	2.1
Net indebtedness to BoE	0.0	0.1	-0.1	-0.1	-4.9	0.2	0.1	0.1	0.0	0.0	-4.5
Tax instruments	—	0.4	0.8	-0.3	0.7	0.7	0.4	0.4	0.4	—	—
PSBR	100.2	8.6	8.9	9.8	10.5	7.9	7.5	7.4	7.1	37.7	205.7

Briefing

Sterling and the Oil Price

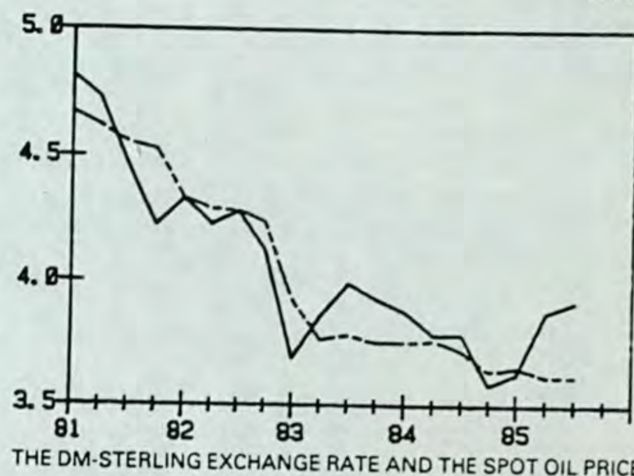
BILL ROBINSON and GILES KEATING

It is a well-known fact that sterling is extremely vulnerable to fluctuations in the oil price. When the oil price rises, sterling rises too and, as chart 1 shows, movements in the exchange rate against the DM are particularly well correlated with fluctuations in the oil price. The volatility of the DM/£ exchange rate reflects movements in the sterling rather than the DM effective exchange rate, which is why sterling is often referred to as a petro-currency. Why does the sterling exchange rate react to changes in the price of oil in this way?

From a long-term perspective there is no mystery about sterling's petro-currency status, which is explained by some old-fashioned balance of payments theory. Britain's North Sea oilfields currently make a contribution of some £20bn per annum to the current-account of the balance of payments. If the oil price falls the contribution is correspondingly less. We have simulated the effects of a fall to $18 per barrel, and in the medium term this worsens the oil account of the balance of payments by around £4bn each year. Unless capital inflows increase by this amount – and there is no reason to think that they would – the non-oil sector of the economy must improve its balance of payments on current account. To secure a £4bn improvement on current price export and import flows which are each of the order of £100bn is not an insuperable task. We estimate that it would require an improvement in cost competitiveness of the order of 5 per cent, with the effect building up over four or five years.

The above reasoning represents the sort of calculation that a Treasury economist might have carried out in the fixed exchange rate era. Had we possessed oil at that time, we might have been obliged to adjust our exchange rate parity in response to changes in its price, and officials would have worked out the required improvement in competitiveness along the lines described above. However we are now living in a world of freely floating exchange rates, with the exchange rate determined by market forces. Is there any reason to believe that the markets will generate exchange rate movements consistent with long-run balance of payments equilibrium?

Chart 1



THE DM-STERLING EXCHANGE RATE AND THE SPOT OIL PRICE

Perhaps the best argument for this proposition is that it is no longer *only* Treasury economists who have to think about the exchange rate. With billions of pounds crossing the foreign exchanges every day and fortunes to be made by predictions of the exchange rate, many expert man-hours are now spent on the problem. In these conditions anything a Treasury economist might work out will be double guessed by the market. The underlying forces driving exchange rates are widely understood and if those forces point to a fall in the exchange rate, the market will react.

Once this is accepted, it is easy to see that the market will always tend to react sooner rather than later. Once new information becomes available that points to (say) a fall in the exchange rate, those who respond most quickly to that information and sell pounds will make money at the expense of those who react more slowly. That is why in the foreign exchange market, as in any other financial market, the long-term effect of any piece of news is discounted – i.e. reflected in today's price – immediately.

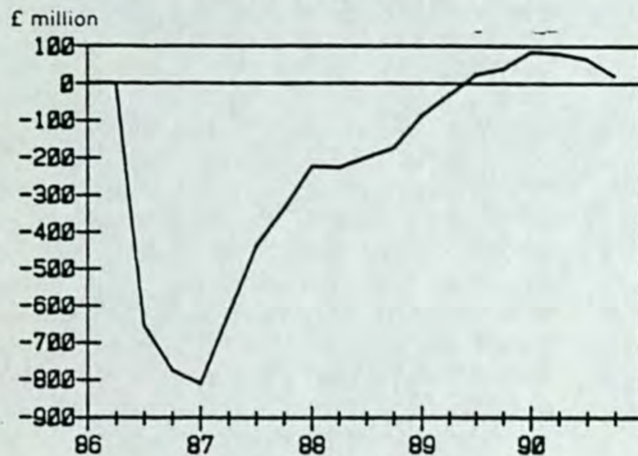
This phenomenon, long known and understood by market participants, is an example of "rational expectations" – i.e. expectations which are formed by making the best rational assessment of future prospects. It is much easier to explain the behaviour of financial markets if it is assumed that expectations are formed in this way.

It is clear from Table 1 that it takes time for the improvement in the non-oil visible account and in invisible earnings to build up to the point where it offsets the deterioration in the oil account. The current account as a whole thus goes into deficit in the immediate aftermath of the oil price shock (Chart 2). Any complete account of the exchange rate and the balance of payments has to explain how this deficit is financed.

(long)

Chart 2

THE IMPACT OF LOWER OIL PRICES ON THE CURRENT ACCOUNT
Difference between base and simulation



The capital account

In the longer term, as we have seen, the exchange rate must find an equilibrium level which balances the current account. But in the short term the current account responds relatively slowly to exchange rate changes. Thus a capital flow is needed to finance the current account surplus or deficit. The exchange rate plays an important role in securing the required capital inflows or outflows.

Table 2 shows how this is done. The key variable is overseas investment by UK residents. In order to finance an increase in the current account deficit there must be a cutback in outward investment by UK residents, and/or an increase in inward investment by foreigners. A fall in the exchange rate brings this about in two ways: a lower exchange rate makes foreign assets more expensive relative to domestic assets and encourages a portfolio shift out of foreign and into domestic securities. The shift occurs partly because the expected return on the foreign asset falls - the exchange rate overshoots downwards, and subsequently recovers (Chart 3). While it is recovering overseas assets underperform relative to domestic assets, and this is taken into account by UK investors. However the more important reason is the simple fact that the fall in the exchange rate automatically increases the weight of foreign stocks and shares in the portfolio, since their value rises in sterling terms. As Table 2 shows, it is overseas assets held by UK residents that are most responsive to changes in the exchange rate, and the current account deficit caused by the fall in the oil price is initially financed by a reduction in private portfolio investment overseas.

Table 2
Capital account transactions
£ billion, difference between simulation and base

	UK residents investment abroad	Other capital transactions	Current account balance
1986	2.4	−1.0	−1.4
1987	2.2	0.0	−2.2
1988	0.2	0.6	−0.8
1989	−0.3	0.3	0.0
1990	−0.3	0.0	0.3

(positive numbers indicate reduced capital outflows or increased inflows; negatives indicate higher capital outflows or reduced inflows)

Oil and the current account

Table 1 shows in detail how the lower real exchange rate brings about the required offset to the deterioration in the oil account. The oil shock is assumed to occur in the middle of 1986, so the effect in that year is approximately half that observed in later years. The non-oil visible account improves by £2bn per annum in 1986-7, building up to £3bn by 1990. This mainly reflects increased export volumes following the fall in the real exchange rate.

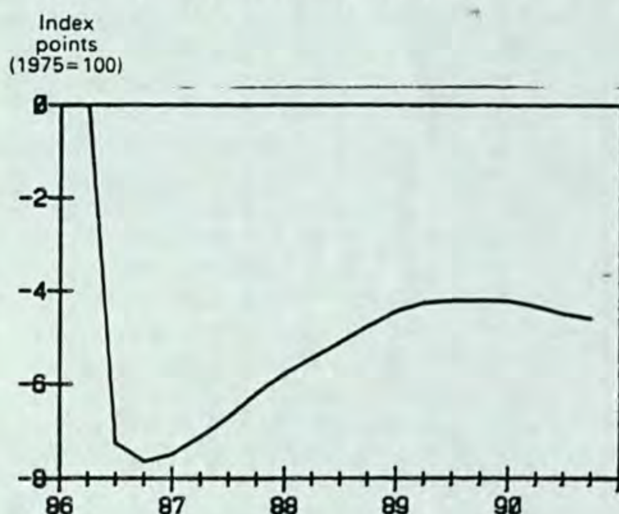
The invisible account improves by £1bn, of which half is accounted for by services and the other half by interest, profits and dividends. The improvement in interest profits and dividends reflects the fact that the UK is a net creditor overseas. When the exchange rate falls, a given flow of foreign currency earnings increases in value in sterling terms.

Table 1
Effect of an oil price shock on the current account
£ billion, difference between simulation and base

	Total current account	Invisible balance	Visible balance: total	non-oil	oil
1986	−1.4	−0.1	−1.3	+0.9	−2.2
1987	−2.2	0.0	−2.2	+2.1	−4.3
1988	−0.8	+0.9	−1.7	+2.5	−4.2
1989	0.0	+1.1	−1.2	+2.8	−4.0
1990	+0.3	+1.2	−0.9	+2.9	−3.8

Chart 3

THE IMPACT OF LOWER OIL PRICES ON THE EXCHANGE RATE
Difference between base and simulation



Rational and adaptive expectations compared

Perhaps the most persuasive argument in favour of rational expectations models is that they give a coherent account of the large discrete movements which are so characteristic of the foreign exchange markets (as of other financial markets) The economic variables which macro-economic models have mainly attempted to explain – GDP and the components of demand, prices, wages and employment – typically follow a smooth path, with no sudden changes of direction. This kind of behaviour is readily modelled by the adaptive expectations approach. But it is almost impossible, using that approach, to model the discrete jumps which occur in the exchange rate. The rational expectations approach by contrast offers both a more convincing explanation of the behaviour of economic agents at the micro-economic level and a better fit of the macroeconomic facts.

It is widely believed that the propensity of the foreign exchange markets to anticipate change rather than reacting adaptively is destabilising. It is less widely recognised that adaptive expectations can also set the economy off on an unstable path. If we simulate an oil price shock assuming that expectations are adaptive, we find the following sequence of events occurs: the current account worsens, which pushes the exchange rate down slightly. In the short term this makes the current account worse still and the exchange rate falls still further. It is a well known fact that currency depreciation will in the short run make the current account worse – the J-curve effect. In these circumstances there is an obvious risk that a depreciation will be destabilising, with the current account sliding down the adverse section of the J-curve and inducing further depreciations that carry the exchange rate below its long-term equ[illegible]ium

By contrast when we simulate the same shock assuming rational expectations we find that the exchange rate and current account of the balance of payments follow the paths illustrated below. The exchange rate jumps directly to a new value close to the long-term equilibrium, the current account deteriorates and then comes back into balance (We assume that in the long term the UK is neither a net exporter nor a net importer of capital.)

The picture of exchange rate behaviour given above may seem too good to be true. Certainly the Panglossian view of the exchange rate adjusting automatically to the 'correct' level in response to an oil price shock contrasts starkly with the exchange rate gyrations that we witness in the real world. Should we conclude from this that our model, nice though it may appear in theory, simply does not work in practice?

There is an alternative explanation. The fact that foreign exchange markets, like other financial markets, are forward looking means that they will respond rationally to new information. But their great virtue – that they respond quickly to news – is also their greatest weakness. They are extremely susceptible to rumour. When we model an oil price shock we treat it as though everyone believes it with certainty. In the real world the probability that oil prices might fall varies constantly, and these variations are reflected in the exchange rate. Exchange rates are volatile because expectations about the variables that determine them are volatile. This does not exclude the possibility of a decisive response to a clear piece of news (as for example when OPEC announces a new marker price).

Reducing exchange rate variability

It thus appears to be a fact of life that the UK exchange rate is uniquely vulnerable to fluctuations caused by changes in expectations about the oil price. Moreover an unstable exchange rate undoubtedly makes life hard for business planning. One of the objectives of the present government has been to create a more stable macro-economic environment – the Medium Term Financial Strategy was intended to produce, and has largely delivered, a lower and more stable rate of inflation. But any decrease in inflation uncertainty has been more than matched by an increase in exchange rate uncertainty. To the extent that this results from increasing uncertainty about the future course of oil prices, the problem is not of the government's own making. But given the disruption that exchange rate fluctuations cause, the authorities should be pursuing policies which minimise them.

It appears that, since the January crisis, the authorities have decided that large movements in the exchange rate must be avoided *whatever their*

cause. In practice this means that if rumours of another oil price cut hit the foreign exchange markets, interest rates have to rise to protect the pound.

In a recent article[1] we proposed a way to reduce the vulnerability of the exchange rate to oil price fluctuations, without the need for interest rate changes. We proposed the issue of oil bonds. The return on these would be linked to the oil price, and the UK would sell them to other countries, buying conventional debt with the proceeds.

[1] See 'Counter-inflationary policy, oil and the EMS', by Bill Robinson, Giles Keating and Michael Smyth, LBS Economic Outlook Vol 10 no 1, October 1985, pp17-27.

If oil prices followed the expected path, then the payments on the oil bonds would equal the receipts from the conventional debt and so there would be no net flow of funds. When an unexpected oil shock occurred, the payments on the oil bonds would alter, compensating partly or fully for the change in our oil revenues. This would occur whether the oil price went up or down.

Since the most likely path for the oil price is for some decline over the next few years, at least in real terms, it may appear that we will be forced to sell the oil bonds at an unduly low price in order to persuade other countries to buy them. This argument is correct only if we in the UK take a more optimistic view about oil prices than the countries to which we are

Rational expectations

Rational expectations have come to play an important part in contemporary economic literature. They are usually contrasted with adaptive expectations, which are typically formed by looking at recent past behaviour and extrapolating it. Until recently economic behaviour was modelled, in most of the large macro-economic forecasting systems, on the assumption that expectations are adaptive. This approach was justified to the extent that the adaptive model gives a plausible account of wage behaviour. Past and present inflation rates do appear to explain wages at least as well as expected future inflation rates. But a great impetus was given to the rational expectations approach as exchange rate modelling became increasingly important.

The exchange rate is today one of the key variables in any macroeconomic model of the economy. Moreover it is obvious that exchange rate behaviour now has much in common with stock and bond market behaviour. The exchange rate is an asset price and can only be properly explained in the context of a complete model of other asset prices. But it is quite inappropriate to model asset prices using adaptive expectations. Specialist share analysts are highly paid to bring to bear all available information in order to assess the likely future value of stocks in their sector of the market. These prices are based on rational expectations about the future, not on extrapolation of the past. Over the twelve years since the move to freely floating exchange rates the same sort of expertise has been gradually built up in the foreign exchange markets.

Macroeconomic modelling and forecasting has until recently tended to ignore the behaviour of financial markets. The early models were built when exchange rates were fixed and could be treated exogenously. Interest rates were treated, with less justification, in the same way. The behaviour of equity markets was ignored even though it had significant consequences for the financing of investment. Under these circumstances it was possible to build reasonably successful macroeconomic models using adaptive expectations. But the move to floating exchange rates changed the situation completely. Given the importance of exchange rates – notably in the determination of prices – and the fact that they can only be properly modelled using rational expectations, that assumption is now a necessary (though alas not a sufficient) condition for the proper modelling of the economy.

The conversion of macro-models to rational expectations has nevertheless been slow, and there are good practical reasons for this. The solution of models on the assumption that all expectations about the future are based on the predictions of the model itself presents severe technical difficulties. It requires a complex iteration over time (typically ten years) which is superimposed on the usual quarter-by-quarter iteration over all the variables in the model. Solving the LBS model, which has many hundreds of variables, in a rational expectations framework is a huge computational task. It is only recently that we have acquired sufficient computing power to make rational expectations forecasts a practical possibility.

selling the bonds. If our views and theirs coincide, then the price will be an accurate reflection of the net present value of the future stream of oil revenues.

The attraction of the oil bonds is that the information-sensitive foreign exchange markets will know that we have insulated our current account from all or part of the effects of the oil price change. They will realise that with a reduced or eliminated impact on the current account, there will no longer be any need for the offsetting capital account flows, and so no need for a large exchange rate adjustment to generate those flows. This will apply not just the next time an oil price shock occurs, but on every occasion when there is a rumour of a possible change. A major source of exchange rate fluctuations will thus be removed.

Table 3
How oil bonds reduce the impact of oil price shocks
£ billion, difference between simulation and base

	Without oil bonds		With oil bonds	
	of which:		of which:	
	Current account	Interest, profits and dividends	Current account	Interest, profits and dividends
1986	−1.4	+0.2	−0.3	+0.8
1987	−2.2	+0.6	−0.9	+1.6
1988	−0.8	+0.4	−0.3	+1.5
1989	0.0	+0.1	+0.6	+1.2
1990	+0.3	−0.1	+1.0	+1.1

Table 3 shows how the oil bonds could reduce the impact of oil price shocks on the current account. We assume that approximately half the impact of any oil price changes has been hedged by the issue of the bonds. This means that the fall from $26 dollars per barrel to $18 in our simulations results in a fall in payments on the bonds of just under £1½bn per annum, with the receipts from the conventional bonds unchanged. As Table 3 shows, there are some other minor offsetting effects in the interest profits and dividends category, but the overall effect is to reduce substantially the impact of the oil price shock on the current account.

Corresponding to the reduced effect on the current account, a smaller capital account adjustment is required and the exchange rate moves by less. This is shown in Table 4, which indicates that the issue of the oil bonds reduces the impact effect on the exchange rate by half, with even larger effects in later years.

Table 4
How oil bonds reduce exchange rate volatility
Index points, difference from base

	Oil price shock without oil bonds	Oil price shock with oil bonds
1986	−3.6	−1.9
1987	−6.5	−3.4
1988	−4.7	−1.7
1989	−3.2	−0.3
1990	−2.3	+0.2

Matrices of asset flows and stocks

The following pages analyse in detail the asset flows for each financial year from 1981/82 to 1988/89 and asset stocks at the end of each year.

1981/82 Financial Year

ASSET FLOWS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVESTMENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	518	-87		-317	4				-118
2 Sterling Sight Deposits	926	261		-2011	159	372	46	206	39
3 Sterling Time Deposits ...- excluding C.D.'s	2546	3110	3553	-11042	305	704	92	557	173
4 Building Society Shares	7036				-7036				
5 Gilts and other ...long term public debt	1622	-160	201	516	1108	4258	-16		-7529
6 Equities and debentures	-2467	-1822	1163	-103		3142	-263		350
7 Overseas securities	26	2438	-5694			2869	525	-164	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	194	-1176	2445	264		116	3	-1015	-830
10 Bank loans excl. mortgages	-4328	-5713	-3424	11071		-74	-28	-1669	4166
11 House purchase loans	-10403			3093	5883	61		528	838
12 Hire purchase loans	-32	591						-559	
13 Sterling C.D.'s - banks		-274	139	-55	103	87			
14 Building Society C.D. issue		53		0	-106	53			
15 Treasury Bills and Local ...Authority Bills		-81	-106	-140	-41	174			194
16 Nat. Savings Certificates	3605								-3605
17 National Savings S.A.Y.E	86								-86
18 Other National Savings	533								-533
19 Banker's deps. -Operational				217					-217
20 Bankers deposits - cash ...ratio plus special deps.				-175					175
21 Govt. indebtedness to B.O.E ...net of banker's deposits				13					-13
22 Net Trade Credit	0	-1792	648						1144
23 Equity in ins.& pens.funds	13212					-13212			
24 Accruals Adjustments	431	-997			-204			-58	828
25 Unit Trust units	149						-149		
26 Other assets including ...unidentified & seas.adj.	-934	5691	-3291	-74	0	-1105		5282	-861
27 Financial Balance	12720	42	-4998	1289	176	-2554	210		-5885

1981/82 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	8547	1770		1134	38				-11489
2 Sterling Sight Deposits	17728	4990		-27239	647	1346	94	1178	1254
3 Sterling Time Deposits ...- excluding C.D.'s	29202	11525	15578	-62564	1162	2418	185	2101	389
4 Building Society Shares	58471				-58471				
5 Gilts and other ...long term public debt	16950	1241	6689	19433	9796	35245	363		-89718
6 Equities and debentures	44250	-83843	10432	-16294		45774	-319		0
7 Overseas securities	4628	8816	-36624			10549	5238	7392	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	1025	-4151	-2422	1415		296	-59	-3891	7787
10 Bank loans excl. mortgages	-20917	-38019	-13182	75574		-309	-87	-10006	6947
11 House purchase loans	-64728			6751	50327	2199			5451
12 Hire purchase loans	-2730	1056						1674	
13 Sterling C.D.'s - banks		806	314	-1681	436	125			
14 Building Society C.D. issue		299	0	0	-448	149			
15 Treasury Bills and Local ...Authority Bills		638	423	1113	1209	787			-4170
16 Nat. Savings Certificates	12333								-12333
17 National Savings S.A.Y.E	657								-657
18 Other National Savings	6490								-6490
19 Banker's deps. -Operational				217					-217
20 Bankers deposits - cash ...ratio plus special deps.				342					-342
21 Govt. indebtedness to B.O.E net of banker's deposits				-460					460
22 Net Trade Credit	2100	-3179	721						358
23 Equity in ins.& pens.funds	125500					-125500			
24 Accruals Adjustments	1239	-6884			-1276			-516	7437
25 Unit Trust units	3215						-3215		
26 Other assets including ...unidentified & seas.adj.	-1770	-2260	-2444	0	450	5059		7285	-6885
27 Net financial wealth	242190	-107194	-20513	-2259	3871	-21857	2200	5217	-102218

1982/83 Financial Year

ASSET FLOWS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST -MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	1324	79		-227	10				-1186
2 Sterling Sight Deposits	3271	392		-4463	7	415	17	343	17
3 Sterling Time Deposits									
...- excluding C.D.'s	2344	471	4476	-8918	0	711	29	584	301
4 Building Society Shares	10347				-10347				
5 Gilts and other									
...long term public debt	597	236	587	-2730	915	3172	149		-2926
6 Equities and debentures	-3224	-229	622	-518		3451	-203		101
7 Overseas securities	-69	3060	-7475			3600	1111	-227	
8 Direct investment									
...to or by overseas		0	0						
9 Other foreign currency inc.									
...reserves & net bank deps.	-26	80	1936	-362		-2	-80	61	-1608
10 Bank loans excl. mortgages	-4653	-3273	-3994	14460		-383	-14	-1841	-321
11 House purchase loans	-15061			4848	9625	-18		0	606
12 Hire purchase loans	-532	123						409	
13 Sterling C.D.'s - banks		216	10	-289	147	-84			
14 Building Society C.D. issue		42		0	-205	163			
15 Treasury Bills and Local									
...Authority Bills		77	165	-305	-523	38			548
16 Nat. Savings Certificates	1187								-1187
17 National Savings S.A.Y.E	-20								20
18 Other National Savings	1870								-1870
19 Banker's deps. -Operational				-52					52
20 Bankers deposits - cash									
...ratio plus special deps.				94					-94
21 Govt. indebtedness to B.O.E									
...net of banker's deposits				-111					111
22 Net Trade Credit	750	-585	246						-411
23 Equity in ins.& pens.funds	13588					-13588			
24 Accruals Adjustments	116	-326			189			20	1
25 Unit Trust units	226						-226		
26 Other assets including									
...unidentified & seas.adj.	-2082	4190	-1798	320	0	1333		837	-1258
27 Financial Balance	9953	4554	-4957	1653	-182	-1190	784		-9104

1982/83 Financial Year

ASSET STOCKS £ MILLION	PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	9871	1849		907	48				-12675
2 Sterling Sight Deposits	21012	5387		-31724	654	1761	111	1525	1271
3 Sterling Time Deposits ...- excluding C.D.'s	31593	12010	20356	-71853	1162	3130	215	2694	690
4 Building Society Shares	68818				-68818				
5 Gilts and other ...long term public debt	18665	1321	8527	16761	13097	44970	468		-103811
6 Equities and debentures	53450	-111823	12946	-14564		60271	-280		0
7 Overseas securities	6798	17324	-63242			22016	7223	9880	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	1213	-4676	-906	1135		357	-101	-4488	7466
10 Bank loans excl. mortgages	-25664	-41397	-17344	90432		-692	-101	-11859	6626
11 House purchase loans	-79789			11599	59952	2181			6057
12 Hire purchase loans	-3168	1179						1989	
13 Sterling C.D.'s - banks		1034	324	-1982	583	41			
14 Building Society C.D. issue		341	0	0	-653	312			
15 Treasury Bills and Local ...Authority Bills		715	588	808	686	825			-3622
16 Nat. Savings Certificates	13520								-13520
17 National Savings S.A.Y.E	637								-637
18 Other National Savings	8360								-8360
19 Banker's deps. -Operational				165					-165
20 Bankers deposits - cash ...ratio plus special deps.				436					-436
21 Govt. indebtedness to B.O.E net of banker's deposits				-571					571
22 Net Trade Credit	2850	-3764	967						-53
23 Equity in ins.& pens.funds	162000					-162000			
24 Accruals Adjustments	1355	-7210			-1087			-496	7438
25 Unit Trust units	5130						-5130		
26 Other assets including ...unidentified & seas.adj.	-1912	-68	-4242	0	450	4931		8028	-6241
27 Net financial wealth	294739	-127777	-42025	1548	6075	-21892	2406	7274	-119401

1983/84 Financial Year

ASSET FLOWS £ MILLION

	PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	117	61		72	24				-274
2 Sterling Sight Deposits	1822	2115		-5131	350	624	155	-82	145
3 Sterling Time Deposits ...- excluding C.D.'s	-842	918	3957	-6052	628	1121	334	-195	131
4 Building Society Shares	11824				-11824				
5 Gilts and other ...long term public debt	1895	519	1105	-975	1735	5211	214		-9704
6 Equities and debentures	-3268	317	1198	283		2442	80		-1052
7 Overseas securities	1409	1973	-6225			2306	882	-345	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	12	1505	503	-584		157	-380	-1016	-197
10 Bank loans excl. mortgages	-4252	-3973	-3451	11502		-432	-1	-2512	3120
11 House purchase loans	-14688			3864	11049	186		0	-411
12 Hire purchase loans	-680	-220						900	
13 Sterling C.D.'s - banks		-191	259	-847	656	123			
14 Building Society C.D. issue		848		632	-1773	293			
15 Treasury Bills and Local ...Authority Bills		-91	-21	103	97	103			-191
16 Nat. Savings Certificates	1281								-1281
17 National Savings S.A.Y.E	4								-4
18 Other National Savings	1999								-1999
19 Banker's deps. -Operational				28					-28
20 Bankers deposits - cash ...ratio plus special deps.				64					-64
21 Govt. indebtedness to B.O.E ...net of banker's deposits				-235					235
22 Net Trade Credit	1350	-1052	185						-483
23 Equity in ins.& pens.funds	14616					-14616			
24 Accruals Adjustments	509	-427			-330			-59	307
25 Unit Trust units	813						-813		
26 Other assets including ...unidentified & seas.adj.	-4271	3633	-48	-420	0	255		3311	-13
27 Financial Balance	9650	5936	-2538	2169	613	-2225	471		-11763

1983/84 Financial Year

ASSET STOCKS £ MILLION	PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	9988	1910		979	72				-12949
2 Sterling Sight Deposits	22834	7502		-36855	1005	2386	267	1443	1416
3 Sterling Time Deposits ...- excluding C.D.'s	30751	12928	24313	-77905	1790	4251	550	2498	821
4 Building Society Shares	80642				-80642				
5 Gilts and other ...long term public debt	19329	1692	10036	15787	15806	52317	549		-115518
6 Equities and debentures	67600	-145317	18445	-17060		78048	-1716		0
7 Overseas securities	8147	20188	-76017			26037	11477	10167	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	1269	-3230	-1584	2736		535	-101	-7241	7616
10 Bank loans excl. mortgages	-29916	-45370	-20795	101934		-1124	-103	-14371	9746
11 House purchase loans	-94477			15463	71001	2367			5646
12 Hire purchase loans	-3848	959						2889	
13 Sterling C.D.'s - banks		843	583	-2829	1239	164			
14 Building Society C.D. issue		1189	0	632	-2426	605			
15 Treasury Bills and Local ...Authority Bills		624	567	911	783	928			-3813
16 Nat. Savings Certificates	14801								-14801
17 National Savings S.A.Y.E	641								-641
18 Other National Savings	10359								-10359
19 Banker's deps. -Operational				193					-193
20 Bankers deposits - cash ...ratio plus special deps.				500					-500
21 Govt. indebtedness to B.O.E net of banker's deposits				-806					806
22 Net Trade Credit	4200	-4816	1152						-536
23 Equity in ins.& pens.funds	207500					-207500			
24 Accruals Adjustments	1864	-7637			-1417			-555	7745
25 Unit Trust units	7580						-7580		
26 Other assets including ...unidentified & seas.adj.	-2188	-280	-4290	0	450	1004		11339	-2776
27 Net financial wealth	357076	-158814	-47588	3646	7662	-39978	3343	6169	-128291

1984/85 Financial Year

ASSET FLOWS £ MILLION

		PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1	Notes and Coin	556	190		118	10				-874
2	Sterling Sight Deposits	4291	1707		-7199	0	673	186	358	-16
3	Sterling Time Deposits ...- excluding C.D.'s	-200	2496	9012	-14416	88	1473	380	792	372
4	Building Society Shares	12328				-12328				
5	Gilts and other ...long term public debt	3319	-197	1512	-66	-38	5269	84		-9883
6	Equities and debentures	-2503	-741	3365	-2349		4085	230		-2087
7	Overseas securities	1324	6921	-9722			1667	248	-438	
8	Direct investment ...to or by overseas		0	0						
9	Other foreign currency inc. ...reserves & net bank deps.	315	-3930	5881	1627		225	-33	-3693	-393
10	Bank loans excl. mortgages	-4778	-7547	-7773	23562		-1005	-1	-2374	-84
11	House purchase loans	-16774			2490	14383	172		0	-271
12	Hire purchase loans	-491	-131						622	
13	Sterling C.D.'s - banks		-348	125	502	-404	125			
14	Building Society C.D. issue		160		644	-976	172			
15	Treasury Bills and Local ...Authority Bills		-23	90	362	-53	319			-695
16	Nat. Savings Certificates	1707								-1707
17	National Savings S.A.Y.E	16								-16
18	Other National Savings	1377								-1377
19	Banker's deps. -Operational				-97					97
20	Bankers deposits - cash ...ratio plus special deps.				82					-82
21	Govt. indebtedness to B.O.E ...net of banker's deposits				-4839					4839
22	Net Trade Credit	1324	-975	117						-466
23	Equity in ins.& pens.funds	16579					-16579			
24	Accruals Adjustments	770	258			-246			-148	-634
25	Unit Trust units	544						-544		
26	Other assets including ...unidentified & seas.adj.	-8626	9615	-2024	1779	0	850		4880	139
27	Financial Balance	11078	7455	583	2169	436	-2552	551		-13137

1984/85 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	10544	2100		1097	82				-13823
2 Sterling Sight Deposits	27125	9209		-44054	1004	3059	453	1801	1400
3 Sterling Time Deposits ...- excluding C.D.'s	30551	15424	33325	-92321	1879	5725	930	3291	1193
4 Building Society Shares	92970				-92970				
5 Gilts and other ...long term public debt	20320	1940	10911	15688	14839	54269	877		-118845
6 Equities and debentures	88626	-200789	24537	-10682		100187	-1879		0
7 Overseas securities	11021	39542	-114674			38959	12449	12703	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	1734	-7974	1163	7295		922	-108	-12023	8990
10 Bank loans excl. mortgages	-34694	-52917	-28568	125496		-2129	-104	-16745	9662
11 House purchase loans	-111251			17953	85384	2539			5375
12 Hire purchase loans	-4339	828						3511	
13 Sterling C.D.'s - banks		495	708	-2327	835	289			
14 Building Society C.D. issue		1349	0	1276	-3402	777			
15 Treasury Bills and Local ...Authority Bills		601	657	1273	730	1247			-4508
16 Nat. Savings Certificates	16508								-16508
17 National Savings S.A.Y.E	657								-657
18 Other National Savings	11736								-11736
19 Banker's deps. -Operational				95					-95
20 Bankers deposits - cash ...ratio plus special deps.				582					-582
21 Govt. indebtedness to B.O.E net of banker's deposits				-5645					5645
22 Net Trade Credit	5524	-5791	1269						-1002
23 Equity in ins.& pens.funds	244085					-244085			
24 Accruals Adjustments	2634	-7379			-1663			-703	7111
25 Unit Trust units	8685						-8685		
26 Other assets including ...unidentified & seas.adj.	-2007	5075	-6314	0	450	-2285		16219	-1296
27 Net financial wealth	420430	-198286	-76985	15638	7169	-40523	3932	8055	-129676

1985/86 Financial Year

ASSET FLOWS £ MILLION	PERS- ONAL SECTOR	ICC'S	OVER- SEAS SECTOR	MONET- ARY SECTOR	BUILD- ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST -MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	319	125		30	22				-499
2 Sterling Sight Deposits	4931	-1620		-3877	269	116	59	68	53
3 Sterling Time Deposits ...- excluding C.D.'s	1831	2414	2645	-7746	238	87	157	124	247
4 Building Society Shares	11780				-11780				
5 Gilts and other ...long term public debt	1225	146	2352	-1050	-1191	4063	155		-5700
6 Equities and debentures	-2220	-2156	343	-219		6245	547		-2540
7 Overseas securities	1071	1427	-6032			2539	994	0	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	940	2384	-520	-2554		-14	-235	0	0
10 Bank loans excl. mortgages	-5758	-6040	-5893	16433		-80	-9	-1540	2890
11 House purchase loans	-16447			3005	13219	497		0	-275
12 Hire purchase loans	-455	31						424	
13 Sterling C.D.'s - banks		910	-238	-1894	1306	-83			
14 Building Society C.D. issue		-751		1924	-1848	675			
15 Treasury Bills and Local ...Authority Bills		-28	-94	48	697	524			-1148
16 Nat. Savings Certificates	1047								-1047
17 National Savings S.A.Y.E	68								-68
18 Other National Savings	1490								-1490
19 Banker's deps. -Operational				208					-208
20 Bankers deposits - cash ...ratio plus special deps.				26					-26
21 Govt. indebtedness to B.O.E ...net of banker's deposits				0					0
22 Net Trade Credit	197	-206	48						-38
23 Equity in ins.& pens.funds	17185					-17185			
24 Accruals Adjustments	604	-279			-63			-26	-234
25 Unit Trust units	800						-800		
26 Other assets including ...unidentified & seas.adj.	-4985	10088	2584	-2017	1	1022		969	-233
27 Financial Balance	13636	6444	-4806	2404	871	-1592	869		-10512

1985/86 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	10863	2225		1127	104				-14322
2 Sterling Sight Deposits	32056	7588		-47931	1273	3175	513	1870	1453
3 Sterling Time Deposits - excluding C.D.'s	32382	17838	35970	-100067	2117	5813	1088	3416	1440
4 Building Society Shares	104750				-104750				
5 Gilts and other ...long term public debt	26539	2542	16109	18110	16904	71068	874		-152149
6 Equities and debentures	94968	-224702	27585	-12063		117468	-592		-2664
7 Overseas securities	9272	39733	-117268			40393	15582	12286	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	2858	-4739	486	3974		821	-668	-10831	8099
10 Bank loans excl. mortgages	-40452	-58957	-34461	141929		-2209	-113	-18286	12552
11 House purchase loans	-127698			20958	98603	3036			5100
12 Hire purchase loans	-4794	859						3935	
13 Sterling C.D.'s - banks		1405	469	-4221	2141	205			
14 Building Society C.D. issue		597	0	3200	-5250	1452			
15 Treasury Bills and Local ...Authority Bills		572	562	1321	1427	1771			-5656
16 Nat. Savings Certificates	17555								-17555
17 National Savings S.A.Y.E	725								-725
18 Other National Savings	13226								-13226
19 Banker's deps. -Operational				304					-304
20 Bankers deposits - cash ...ratio plus special deps.				608					-608
21 Govt. indebtedness to B.O.E ...net of banker's deposits				-5645					5645
22 Net Trade Credit	5721	-5997	1317						-1040
23 Equity in ins.& pens.funds	285674					-285674			
24 Accruals Adjustments	3238	-7658			-1726			-729	6876
25 Unit Trust units	11123						-11123		
26 Other assets including ...unidentified & seas.adj.	-6992	15164	-3729	-2017	451	-1262		17168	-1528
27 Net financial wealth	471017	-213526	-72958	19588	11298	-43941	5560	8830	-168615

1986/87 Financial Year

ASSET FLOWS £ MILLION	PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST -MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	473	172		72	10				-729
2 Sterling Sight Deposits	233	1936		-2754	135	157	125	92	72
3 Sterling Time Deposits ...- excluding C.D.'s	2219	2001	2407	-9372	214	2111	176	169	71
4 Building Society Shares	10611				-10611				
5 Gilts and other ...long term public debt	1420	257	7	-877	-1017	6055	154		-6000
6 Equities and debentures	-2666	-801	753	-239		5893	561		-3500
7 Overseas securities	-177	2085	-3551			617	1024	0	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	378	904	-866	-192		40	-264	0	0
10 Bank loans excl. mortgages	-5038	-4717	-1715	12320		-109	-14	-2512	1788
11 House purchase loans	-17138			3439	12834	1065		0	-200
12 Hire purchase loans	-842	42						799	
13 Sterling C.D.'s - banks		1166	-172	-808	-61	-124			
14 Building Society C.D. issue		-729		1600	-1250	379			
15 Treasury Bills and Local ...Authority Bills		187	218	65	-40	170			-600
16 Nat. Savings Certificates	656								-656
17 National Savings S.A.Y.E	100								-100
18 Other National Savings	923								-923
19 Banker's deps. -Operational				25					-25
20 Bankers deposits - cash ...ratio plus special deps.				51					-51
21 Govt. indebtedness to B.O.E ...net of banker's deposits				0					0
22 Net Trade Credit	294	-287	65						-72
23 Equity in ins.& pens.funds	17900					-17900			
24 Accruals Adjustments	162	-380			726			-36	-472
25 Unit Trust units	800						-800		
26 Other assets including ...unidentified & seas.adj.	976	5813	738	-700	18	40		1486	-215
27 Financial Balance	11288	7650	-2113	2629	958	-1602	963		-11616

1986/87 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVESTMENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	11337	2398		1200	115				-15051
2 Sterling Sight Deposits	32290	9525		-50686	1409	3333	638	1963	1525
3 Sterling Time Deposits ...- excluding C.D.'s	34601	19839	38377	-109440	2332	7924	1264	3586	1512
4 Building Society Shares	115362				-115362				
5 Gilts and other ...long term public debt	28306	2833	16316	17444	16082	78024	1040		-160048
6 Equities and debentures	94410	-229997	28909	-12549		125800	-278		-6296
7 Overseas securities	9885	45250	-130891			44462	17962	13330	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	3363	-4016	-377	3944		895	-964	-11284	8438
10 Bank loans excl. mortgages	-45491	-63675	-36177	154249		-2319	-127	-20798	14340
11 House purchase loans	-144836			24397	111437	4101			4900
12 Hire purchase loans	-5636	902						4734	
13 Sterling C.D.'s - banks		2572	296	-5030	2080	81			
14 Building Society C.D. issue		-132	0	4800	-6500	1832			
15 Treasury Bills and Local ...Authority Bills		759	781	1387	1386	1942			-6257
16 Nat. Savings Certificates	18211								-18211
17 National Savings S.A.Y.E	825								-825
18 Other National Savings	14150								-14150
19 Banker's deps. -Operational				330					-330
20 Bankers deposits - cash ...ratio plus special deps.				660					-660
21 Govt. indebtedness to B.O.E net of banker's deposits				-5645					5645
22 Net Trade Credit	6015	-6285	1382						-1113
23 Equity in ins.& pens.funds	310776					-310776			
24 Accruals Adjustments	3400	-8039			-999			-765	6404
25 Unit Trust units	12317						-12317		
26 Other assets including ...unidentified & seas.adj.	-6015	20977	-2990	-2717	470	-1222		18655	-1744
27 Net financial wealth	493276	-207086	-84373	22346	12453	-45918	7217	9421	-181924

1987/88 Financial Year

ASSET FLOWS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST-MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	211	188		62	9				-472
2 Sterling Sight Deposits	460	553		-1503	124	161	34	95	73
3 Sterling Time Deposits ...- excluding C.D.'s	3890	1441	2773	-8984	197	189	245	173	73
4 Building Society Shares	9748				-9748				
5 Gilts and other ...long term public debt	-260	292	-487	-620	-833	7753	153		-6000
6 Equities and debentures	-4400	-996	874	-240		7446	563		-3250
7 Overseas securities	-1249	2128	-2155			251	1030	0	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	22	141	-235	283		60	-271	0	0
10 Bank loans excl. mortgages	-5159	-3829	66	9433		-112	-14	-1669	1285
11 House purchase loans	-17346			3576	12782	987		0	0
12 Hire purchase loans	-525	43						481	
13 Sterling C.D.'s - banks		499	-540	7	-260	294			
14 Building Society C.D. issue		-384		1650	-1200	-65			
15 Treasury Bills and Local ...Authority Bills		49	639	67	-173	152			-734
16 Nat. Savings Certificates	265								-265
17 National Savings S.A.Y.E	100								-100
18 Other National Savings	850								-850
19 Banker's deps. -Operational				20					-20
20 Bankers deposits - cash ...ratio plus special deps.				41					-41
21 Govt. indebtedness to B.O.E ...net of banker's deposits				0					0
22 Net Trade Credit	253	-293	66						-26
23 Equity in ins.& pens.funds	18890					-18890			
24 Accruals Adjustments	139	-389			-48			-37	334
25 Unit Trust units	800						-800		
26 Other assets including ...unidentified & seas.adj.	919	8120	237	-1377	22	-50		956	-96
27 Financial Balance	7609	7565	1234	2418	871	-1818	942		-10090

1987/88 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVESTMENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	11548	2586		1263	125				-15524
2 Sterling Sight Deposits	32751	10079		-52190	1534	3494	672	2058	1599
3 Sterling Time Deposits ...- excluding C.D.'s	38492	21281	41150	-118424	2529	8114	1510	3760	1585
4 Building Society Shares	125110				-125110				
5 Gilts and other ...long term public debt	28072	3132	15840	16833	15253	85938	1196		-166267
6 Equities and debentures	92181	-236208	30453	-13077		136219	180		-9748
7 Overseas securities	9086	49549	-139258			46807	19856	13958	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	3410	-3902	-616	4255		962	-1242	-11363	8497
10 Bank loans excl. mortgages	-50651	-67505	-36110	163683		-2431	-141	-22468	15626
11 House purchase loans	-162183			27974	124220	5088			4900
12 Hire purchase loans	-6162	945						5216	
13 Sterling C.D.'s - banks		3071	-243	-5022	1819	375			
14 Building Society C.D. issue		-516	0	6450	-7700	1766			
15 Treasury Bills and Local ...Authority Bills		809	1420	1454	1212	2094			-6991
16 Nat. Savings Certificates	18476								-18476
17 National Savings S.A.Y.E	925								-925
18 Other National Savings	15000								-15000
19 Banker's deps. -Operational				351					-351
20 Bankers deposits - cash ...ratio plus special deps.				702					-702
21 Govt. indebtedness to B.O.E net of banker's deposits				-5645					5645
22 Net Trade Credit	6269	-6578	1449						-1139
23 Equity in ins.& pens.funds	335328					-335328			
24 Accruals Adjustments	3540	-8428			-1047			-803	6738
25 Unit Trust units	13482						-13482		
26 Other assets including ...unidentified & seas.adj.	-5096	29098	-2754	-4095	492	-1272		19611	-1839
27 Net financial wealth	509584	-202586	-88667	24513	13329	-48170	8550	9970	-192376

1988/89 Financial Year

ASSET FLOWS £ MILLION	PERS-ONAL SECTOR	ICC'S	OVER-SEAS SECTOR	MONET-ARY SECTOR	BUILD-ING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVEST -MENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	378	154		63	7				-604
2 Sterling Sight Deposits	998	359		-1987	92	162	205	95	74
3 Sterling Time Deposits ...- excluding C.D.'s	3475	868	3117	-8664	146	568	239	174	73
4 Building Society Shares	7254				-7254				
5 Gilts and other ...long term public debt	-290	271	-630	-492	-762	7752	153		-6000
6 Equities and debentures	-4843	-1102	1090	-239		7532	563		-3000
7 Overseas securities	-1458	1828	-2952			1546	1031	0	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	-26	-192	289	87		112	-272	0	0
10 Bank loans excl. mortgages	-5431	-4990	1415	9085		-113	-15	-940	989
11 House purchase loans	-17225			3693	12889	642		0	0
12 Hire purchase loans	-325	44						281	
13 Sterling C.D.'s - banks		-24	-562	2937	-1644	-705			
14 Building Society C.D. issue		111		50	-1200	1038			
15 Treasury Bills and Local ...Authority Bills		37	708	67	-1096	222			61
16 Nat. Savings Certificates	183								-183
17 National Savings S.A.Y.E	75								-75
18 Other National Savings	1000								-1000
19 Banker's deps. -Operational				15					-15
20 Bankers deposits - cash ...ratio plus special deps.				31					-31
21 Govt. indebtedness to B.O.E ...net of banker's deposits				0					0
22 Net Trade Credit	243	-296	67						-15
23 Equity in ins.& pens.funds	20363					-20363			
24 Accruals Adjustments	134	-391			-48			-37	343
25 Unit Trust units	800						-800		
26 Other assets including ...unidentified & seas.adj.	462	8730	1384	-1517	22	-58		426	-77
27 Financial Balance	5768	5407	3931	3129	1151	-1664	1105		-9460

1988/89 Financial Year

ASSET STOCKS £ MILLION	PERSONAL SECTOR	ICC'S	OVERSEAS SECTOR	MONETARY SECTOR	BUILDING SOCS.	PENS'N FUNDS & INS. COMPS.	UNIT & INVESTMENT TRUSTS	OTHER OFI'S	PUBLIC SECTOR
1 Notes and Coin	11926	2741		1327	132				-16128
2 Sterling Sight Deposits	33750	10438		-54178	1626	3656	878	2153	1673
3 Sterling Time Deposits ... - excluding C.D.'s	41968	22149	44268	-127089	2676	8683	1749	3934	1659
4 Building Society Shares	132365				-132365				
5 Gilts and other ...long term public debt	29028	3551	15906	17080	15152	97729	1407		-179857
6 Equities and debentures	91927	-249776	33178	-14012		151121	907		-13346
7 Overseas securities	7819	52492	-145324			49405	21338	14268	
8 Direct investment ...to or by overseas		0	0						
9 Other foreign currency inc. ...reserves & net bank deps.	3331	-4033	-319	4276		1059	-1494	-11187	8365
10 Bank loans excl. mortgages	-56082	-72495	-34694	172768		-2544	-156	-23409	16615
11 House purchase loans	-179408			31667	137109	5731			4900
12 Hire purchase loans	-6487	989						5497	
13 Sterling C.D.'s - banks		3046	-806	-2085	174	-330			
14 Building Society C.D. issue		-405	0	6500	-8900	2805			
15 Treasury Bills and Local ...Authority Bills		846	2129	1521	116	2316			-6930
16 Nat. Savings Certificates	18660								-18660
17 National Savings S.A.Y.E	1000								-1000
18 Other National Savings	16000								-16000
19 Banker's deps. -Operational				366					-366
20 Bankers deposits - cash ...ratio plus special deps.				733					-733
21 Govt. indebtedness to B.O.E net of banker's deposits				-5645					5645
22 Net Trade Credit	6513	-6874	1516						-1155
23 Equity in ins.& pens.funds	369173					-369173			
24 Accruals Adjustments	3675	-8820			-1096			-840	7082
25 Unit Trust units	14913						-14913		
26 Other assets including ...unidentified & seas.adj.	-4633	37829	-1369	-5612	515	-1331		20038	-1922
27 Net financial wealth	535440	-208319	-85514	27621	15142	-50870	9716	10455	-210160

6

NOTE FOR THE RECORD

MEETING WITH SIR ALAN WALTERS

The Prime Minister today met Sir Alan Walters for about three quarters of an hour.

Sir Alan said he thought policy was if anything a little tight, rather than loose. The yield curve was downward sloping, which suggested that people expected interest rates to fall. There was considerable buoyancy of consumer demand, and the CBI and IOD surveys suggested that confidence was reasonably stable. He saw no reason for a decline in output next year and he thought that output could rise by 3 per cent or even a little more.

The monetary base was growing on average at about 5 per cent and had been for many years. This suggested that inflation itself might continue to run at about 5 per cent, though with variations around that level. The number of small firms was growing well, and productivity seemed likely to increase by 4 per cent or so which was good, though probably not as high as the outstanding rates of 6 per cent or more which had been achieved in the past few years. The UK had had an investment boom. New jobs were being created at a rapid rate, and vacancies were rising strongly. The savings ratio was quite high. There would probably be some tailing off in investment, but the prospects in general seemed good. The main concern must be over the rate of increase in wages.

There were risks, of course, including particularly those arising from the United States. US interest rates at the short end had begun to creep back up a little. The US dollar had fallen, but the high yield on investments in dollars and the demand for world savings arising from the budget deficit meant that there was still a strong possibility that the US dollar could rise again.

Sir Alan outlined the prospects for the Congressional Bill to produce year by year reductions in the budget deficit. It seemed likely that something would be passed, though interested Congressmen were as always using it as an excuse to tack on their own pet proposals.

Sir Alan explained his concerns that if the Government began to slip in the opinion polls during the course of 1986, there could be an outflow of capital which could gather momentum as people tried to beat the rush ahead of an election. The right response would not be to raise interest rates, but to allow sterling to find its own level. The problems of an outflow of capital would be immensely increased if sterling were in the EMS, since the main immediate option then would be to hike interest rates. Fiscal policy might also need to be used. To take sterling out of the EMS or to devalue would both be unattractive options. Sir Alan noted that legislation allowing the re-introduction of exchange controls was still on the statute book and there could be pressure for the controls to be reimposed. Only the Dutch, with the Germans, in the EMS had open capital markets.

DAVID NORGROVE

5 November 1985

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary 30 October 1985

NATIONAL SAVINGS: INDEXED-INCOME BOND

The Prime Minister has seen your letter to me of 29 October. She has noted that Treasury Ministers plan to launch a new National Savings instrument called the Indexed-Income Bond on 11 November.

(David Norgrove)

M. J. Neilson, Esq.,
HM Treasury.

1783/028

CONFIDENTIAL

Prime Minister 2
An ingenious development of National Savings: To be aware.
DLW 30/10.

Treasury Chambers, Parliament Street, SWIP 3AG

David Norgrove, Esq
10 Downing Street
LONDON SW1A 0AA

29 October 1985

Dear David,

NATIONAL SAVINGS : INDEXED-INCOME BOND

The Prime Minister will wish to be aware that Treasury Ministers plan to launch a new National Savings instrument called the Indexed-Income Bond on 11 November. The Economic Secretary intends announcing this when he speaks to the 2nd Savings Banks International Business Symposium on 5 November.

Indexed-Income Bonds will in many respects be similar to conventional Income Bonds (which we will continue to sell): both offer a monthly income upon the investment of a lump-sum. However, whereas the conventional Income Bond offers an interest rate that is variable throughout the Bond's life, the new Bond will offer a fixed interest rate in the first year, which is then uprated annually in line with inflation during the Bond's 10 year life. The initial rate of interest will be 8% gross of tax compared with the current interest rate on the conventional income bond of 12%. The index-linking produces the equivalent of a ten year indexed pension.

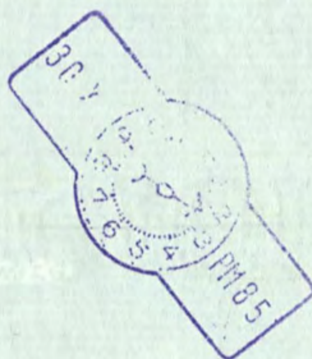
Unlike indexed gilts, the principal will not be indexed. The running yield will be higher (reason).

The aim of the Indexed-Income Bond is to fill a gap in the savings market, and at the same time broaden the range of National Savings instruments. It should appeal particularly to people at or near retirement, or anyone with a lump sum to invest, who is looking for an income that will be protected against inflation.

The inflow that the new Bond will generate cannot be firmly estimated, but it might produce additional sales of between £100 million and £300 million in a full year and although some of this may be offset by lower conventional income bond sales it should assist National Savings in meeting the £3 billion target for 1985-86.

Yours sincerely

M J NEILSON



10 DOWNING STREET

Prime Minister 2

An unhelpful article, drawing large conclusions from small foundations. It shows why the Chancellor is concerned about the presentation of macro-economic policy.

DW

14/10.

FINANCIAL TIMES MONDAY 14th Oct 1985

THE LEX COLUMN

Rising damp at Mansion House

As Mr Lawson stands up to speak at the Mansion House dinner on Thursday, City analysts will be hoping for an explanation of the Government's recent monetary policy, if not a new set of monetary targets. Not only is sterling M3 embarrassingly wide of its target range; the Government has done precious little in the past three or four months to tempt it back.

Traditionally, the Bank of England has controlled a wayward £M3 by selling more gilts to the non-bank private sector than it needs to. Since the late summer, this tactic seems to have been dropped, with the effect that the PSBR has been seriously underfunded in the past two banking months. As a result, perhaps, the annualised growth rate of £M3 over the past six months has been 18½ per cent—more than twice the maximum officially approved rate.

Underfunding

The underfunding could, of course, be accidental — or at least not part of any great Treasury plan. Perhaps the Bank wants to see some natural wastage on the holdings of commercial bills it has built up as a result of past overfunding. But the bill mountain is an irritant at worse; a mere molehill compared with inflation. So it would be odd for the Government to allow broad money to grow this fast purely to reduce friction in the money markets.

It could instead be a policy of creeping reflation. That may not be as direct as spending money on the sewers, but expanding real monetary growth will eventually inject spending power into the economy; and by encouraging spending by private individuals and institutions rather than the State, it suits the Government's book.

After the sharp rise in interest rates—and later, the exchange rate—at the beginning of the year, Mr Lawson may well have been worried that the economy would run out of steam in the run-up to the next election. Now that the exchange rate seems to have found its niche at a more sensible level against the dollar, perhaps he is turning his mind to the creation of jobs through stimulating the economy.

The Government's attitude to public sector pay seems to confirm a more reflationary stance.

Its target for pay rises is supposedly 3 per cent, but an offer of 8 per cent has been made to local authority manual workers, and other employees, such as policemen and firemen, should be winning awards of 7 to 8 per cent. Public sector earnings have fallen well behind the private sector and the Government seems relatively happy to allow catch-up settlements this year.

All this will boost public spending, though at least some can be delayed until after next year's budget. Meanwhile, the Government may have to scratch around to find the £2bn to £3bn it wants for tax cuts. Oil revenues are now likely to be around £3bn less than was projected earlier this year, and higher-than-expected revenues from income and corporation tax will probably take up only £1bn of the shortfall. On the spending side, there could easily be an overshoot of up to £3bn.

The Government can be perfectly justified in dipping into the contingency reserve to help balance its books—after all, it earned more than it expected from oil last year and used the money to replenish its reserves for just such a rainy day. But the rest may have to be found from asset sales, which could rise from a projected £2bn to as much as £3.5bn. If the Government is easing the pressure on the gilt market by underfunding, maybe the plan is to ensure that institutions have enough money to mop up a heavy flow of privatisations in the equity market.

It may seem rather premature to be speculating about pre-election reflation. But on the assumption that the date is to be Autumn 1987 and that reducing unemployment is the Government's top priority, now is probably the time to start. Creating jobs through economic growth rather than specific programmes is a time-consuming process and a two-year lag does not seem excessive.

But the Chancellor's main constraint must be inflation. Having promised so often to keep inflation under control, it would be extremely embarrassing to go into the next election with a rate no lower than today's. Yet with money and wages growing so fast, he may have a hard task on his hands.

Wage settlements have shown no sign of slowing, even though inflation will moderate in the short term once the effects of the weak pound and high mortgage rates have washed through the system. Corporate profitability is high and the share of wages in national income since 1982 (when unemployment more or less stabilised) has been falling at the expense of profits. So private sector employees are trying to win back what they have lost to their employers, while the public sector wants to catch up with the private sector.

Earlier this year, the Government seemed to be using the twin weapons of high interest and exchange rates to concentrate companies' minds for the wage round. Employers were presumably supposed to threaten more redundancies in order to keep wage costs in check. But now that sterling has fallen against the D-Mark, the margin pressure has lessened, and with it the reluctance to pass wage increases on in higher prices. The Government must hope to be bailed out by lower import and commodity costs, which could again allow companies to grant higher wage settlements without raising prices or eating into profit margins.

Room for error

When Mr Lawson sits down for his coffee and brandy, he can at least console himself with the fact that he has some room for error. Though boosting employment takes a long time, controlling inflation is a quicker thing altogether. If the worst happens and prices take off in a year's time, he can at least try to bring down inflation by tightening the monetary reins; and any adverse effect on jobs might not come through until after the election.

MR WICKS 18 September 1985

PAY RESTRAINT

One way to put pressure on the private sector employers is to make pay policy an explicit factor in the consideration of the grant of DTI discretionary aid.

Companies that have awarded pay rises above the going rate should not expect the taxpayer to subsidise them.

Peter Warry

PETER WARRY

982/1

CONFIDENTIAL
COVERING SECRET

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22/8.

FROM: S J DAVIES
20 August 1985

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton o/r
Sir T Burns o/r
Mr A M Bailey
Mr Littler
Mr Byatt o/r
Mr Cassell
Mr Monck o/r
Mr Kemp
Mr Wicks
Mr Evans
Mr Odling-Smee o/r
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Fitchew
Mr Culpin
Mr Gilhooly
Mr Mowl o/r
Miss O'Mara
Miss Peirson
Mr Page
Mr Cropper
Mr H Davies
Mr Lord
Mr Turnbull No 10

NATIONAL INSTITUTE ECONOMIC REVIEW FOR AUGUST

1. The August National Institute Economic Review will be published at 9 pm this evening. As well as the usual economic forecasts the Review contains four papers concerned with various aspects of government borrowing and economic policy. These include a paper contributed by John Odling-Smee and Chris Riley. MP1 are submitting a separate brief on these papers.

The Forecast

2. The Institute are slightly more optimistic about output growth this year and next than they were three months ago, and markedly more optimistic about inflation next year than they

were in May. The revision to the inflation forecast reflects a much higher projection for the UK exchange rate. The forecast is constructed on the assumption that the authorities set monetary policy so as to keep the sterling index close to its current level. The table attached compares the new NIESR forecast with the published FSBR forecast and the Treasury's unpublished June forecast.

Demand and Output

3. The Institute expect GDP (as measured by the output estimate) to rise by about 3½% in 1985. They note that over the past quarter of a century no other period of expansion has lasted as long as the present one. However they also suggest that this phase of expansion "may soon be coming to an end". Output is expected to be more or less flat during 1986; the 1½ per cent increase in GDP they forecast between 1985 and 1986 mainly reflects growth during 1985.

4. Manufacturing output is forecast to fall marginally between 1985 and 1986 after a 2 per cent rise this year. (The Institute's forecast was completed before the CSO's upward revision to 1985 manufacturing output statistics, published last week. The Institute can take credit for suggesting in the text of the Review that the previously published figures for manufacturing output this year were too low. Their own estimates, based on responses to the CBI Survey question on the trend in output, are of a 2 per cent rise in manufacturing output in the four months up to July. This is above the CSO's estimate even as revised, and may well suggest further upward revisions to the official statistics still to come).

5. The components of demand that have been strongest in 1985 - business investment and exports - are expected to be much weaker in 1986, with just a 1 per cent rise in exports of goods and services and about a 2 per cent rise in business investment. With private residential investment flat and further sharp falls in public investment total fixed investment rises by only about ½ per cent in 1986.

6. While the high exchange rate forecast depresses exports, the sharp fall in inflation that it helps to secure means that real incomes rise fast next year. Even without any tax cuts next year, real personal disposable income rises by 4 per cent in 1986. Consumers' expenditure, forecast to grow by 3 per cent next year, is the only component of demand that makes a significant contribution to growth next year.

7. The Institute have halved their forecast of stockbuilding in 1985 as compared with their May forecast. But the 2/3 per cent contribution it makes to growth in 1985 still seems rather high, especially in light of the information now available for the second quarter; and with lower stockbuilding in 1985 there might be rather more contribution to growth from this source in 1986 than shown in the Institute forecast.

8. The Institute's inflation forecast may attract some attention, particularly in view of their record of very pessimistic inflation forecasts in recent years. They now forecast that the RPI will increase by 5½ per cent in the year to the fourth quarter of 1985, and by 3½ per cent in the year to the fourth quarter of 1986. For 1986 as a whole, inflation averages just 3 per cent.

Employment and Unemployment

9. The Institute expect employment growth to flatten during 1986, reflecting the flat path of output. Unemployment may be roughly flat on the narrow definition - ie excluding school leavers - but there may be some fall in the broad definition next year as a result of the extension of the YTS.

Trade and the Current Account

10. Like us, the Institute now expect a current account surplus of some £4½ billion this year (they have revised their forecast up by some £3 billion since May). The forecast shows the current account remaining in healthy surplus (£3 billion) next year as gains in the terms of trade offset the weak performance of exports.

Government Expenditure and the PSBR

11. As has generally been the case in recent NIESR forecasts, the Institute are projecting a much less satisfactory fiscal position in financial year 1986-87 than shown in either the FSBR forecast or in our internal June forecast. It is of some comfort that the Institute, who had earlier on been much more pessimistic about the current financial year, are now in broad agreement with official forecast. But the scale of the disagreement with us on 1986-87 is as great as ever: even with no tax cuts next year, the PSBR is forecast to be some £3½ billion larger than shown in the FSBR forecast.

12. For 1985-86 the Institute's forecast for oil revenues - at over £14 billion - is £½ billion higher than the FSBR forecast and £2 billion above the internal June forecast. For 1986-87, the Institute forecast a sharp fall in oil revenues to £9-9½ billion as sterling appreciates to over $1.50. But this figure for oil revenues is less than £1 billion below our internal June forecast, and hence explains only a small part of the overall discrepancy between the two PSBR forecasts. The main differences are that the National Institute have a lower forecast of non oil taxes on income (reflecting their low employment forecast) and a higher current expenditure forecast (8 per cent growth in current expenditure on goods and services in both years, well ahead of the general rate of inflation).

Monetary growth and interest rates

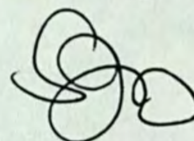
13. The Institute expect £M3 to continue growing at a rate well outside the MTFS target range. MO growth is expected to pick up slightly and is projected at around the top of the target range next year. Short term interest rates are forecast to fall by some 3½ points from current levels by the end of 1986: the Institute think that the behaviour of sterling will be the main determinant of how fast the authorities allow interest rates to fall. They do not expect any significant fall in world interest rates: the scope for such a sizeable fall in UK rates

must therefore be contingent on quite a marked improvement in sentiment towards sterling.

Assessment and line to take

14. While there are clearly some factors which may point towards slower growth next year, some areas of demand may be more buoyant than the Institute suggest. Housing sales have been surprisingly high in recent months and, helped by falling interest rates, residential investment could well pick up more strongly over the next year than shown in the Institute's forecast. Personal consumption could also be significantly stronger, benefitting - as in 1982 and 1983 - from lower inflation and interest rates; and also from the tax cuts which we still expect for next year.

15. The Institute's forecast of a halving in the inflation rate is particularly welcome given their record of pessimistic inflation forecasts. The deterioration in the fiscal prospects that they show is not something that we would accept as a central forecast: their expenditure projections seem very high relative to the general rate of inflation.



S J DAVIES

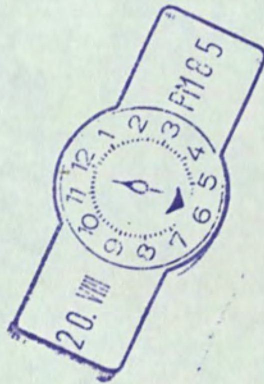
SECRET

	NIESR August forecast	Treasury Unpublished June forecast	Treasury Published FSBR forecast
PSBR (£bn)			
1985-86	7½	7	7
1986-87	11	7½	7½
Fiscal Adjustment (£bn)			
1986-87	0	5½	3½
World Trade in manufactures			
1985	6	7	5½
1986	5	3½	4½
GDP (%)			
1985	3½	3½	3½
1986	1½	2½	2½*
RPI Inflation (%)			
1985 Q4	5½	6	5
1986 Q4	3½	4	4½**
Current Account (£bn)			
1985	4½	4½	3
1986	3	4	3***
Sterling Index			
1985	79	76½	73-74
1986	81	76	73-74

* First half of 1986 on first half of 1985

** 1986 Q2 not Q4

***First half of 1986 at annual rate



NICHOLAS R. WINTERTON, M.P.
(Macclesfield)

1 JF
2 CF

1st August 1985
NRW/cmh

CH/EXCHEQUER
REC. 2 AUG 1985
ACTION Mr Cropper
COPIES TO Mr Lord
Mr Davies
Mr P. Lilley MP
Mr Turnbull

Rt. Hon. Nigel Lawson QC MP
Chancellor of the Exchequer
11 Downing Street
LONDON SW1

Dear Nigel,

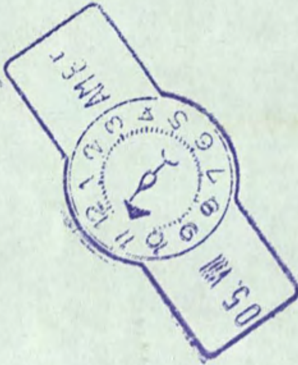
I thank you for your long and informative letter of 26th July which certainly sets out the economic and political situation as you see it. I do feel, however, that your perception is somewhat limited, and you fail to appreciate the damage which has been done to our manufacturing industry and our national infrastructure in recent years.

In seeking to maintain public expenditure at its present level, you have cut the capital sector, while allowing the revenue sectors to run amok. In short, you have used the capital sector, particularly relating to our national infrastructure, as a financial regulator, and in my view the use of any sector of the nation's activities as a financial regulator is not simply misguided expediency, but carries with it its own grave propensity for harm. It is basic logic that if the public authorities, i.e. government, curtail a sector which is not in need of curtailment, it must damage the community and the economy as a whole. Such abuses of the economy's integrity have occurred in the past. The British motor industry was, some thirty years ago, one of the most innovative and vigorous of the economy, and a pioneer in the international field. Successive governments, short of revenue, chose to saddle this industry with every imposition they could devise. Eventually, every form of motor manufacture and motor vehicle use, was subject to some form of taxation. Sandwiched between the upper millstone of these fiscal burdens, and the nether millstone of a greedy workforce, and unfair overseas competition, the British motor industry was reduced to a shadow. Today, it commands less than 50% home market, where once it held 95%.

Today, the construction industry, active and resourceful, high potential employer of labour, technological leaders and high export earner thought it may be, has lost 50% of its workload and a quarter if its workforce, including skilled specialist, perhaps difficult or impossible to replace. The damage, however, self-evidently, does not remain within the construction or motor industries. There is a loss of transport amenity, fast communications, cheap and available utilities, both to industry and to the community at large.
The CBI has expressed this view publicly in its 'Fabric of the Nation in Mid 1984'. It is vital that the Government, before it is too late, reverses this trend, and I ask you

/continued

to open your eyes to the reality of the economic and employment situation facing our country.



Yours ever
[signature]

Prime Minister (2)
To note Chancellor's end of term message
AT 30/7

11 DOWNING STREET
WHITEHALL SW1A 2AB

26 July 1985

As the House rises for the long summer recess, I thought it might be helpful if I took this opportunity to set out how I see the current economic situation and the prospects for the second half of this Parliament.

I must say I had expected that, before we rose, the Opposition would have given me the opportunity to do so on the floor of the House. Their lack of stomach for the customary end-July censure debate is either a backhanded tribute to the current state of the economy, or a tacit admission of their own lack of self-confidence - or both.

Certainly, the economy has made excellent progress since we were re-elected in June 1983.

By the time of that election, the economy had just about recovered from the worst world recession since the 1930s: total national output had climbed back from the trough of 1981 to regain the 1979 pre-recession peak. Since then, since the election, we have forged ahead.

Our overall economic growth in 1983 as a whole, at a shade over 3 per cent, turned out to be the highest in the European Community. Last year, 1984, we were inevitably held back by Mr Scargill's coal strike - but even so our growth rate of over 2½ per cent was well above the EEC average. And this year the likelihood is that the economy will grow by a further 3½ per cent, once again the highest growth rate in the Common Market and in all probability higher than the United States, too.

For Britain, this is a performance without precedent. And with this steady expansion has of course gone steadily higher living standards.

No less important, and in contrast to all previous economic upswings over the past 20 years, the present expansion has <u>not</u> been accompanied by a resurgence of inflation. It is true that with inflation down to 4½ per cent in 1983 it edged up slightly to 5 per cent in 1984 and is likely to average around 6 per cent this year. But the worst of this setback is now behind us, and we can reasonably look forward to an inflation rate below 5 per cent again next year. Compare this with the last Labour Government's <u>average</u> inflation rate of <u>over 15 per cent</u>. I regard the maintenance of continued downward pressure on inflation as essential - an economic, political and moral imperative.

So far, however, the undoubted economic success I have just described has been to a considerable extent obscured in the public mind by the high level of unemployment.

I am acutely conscious of the need to do all we possibly can to help people back into work. But this does not - and must not - mean putting into reverse the policies that have brought us the inestimable benefits of steady growth and low inflation. In this country we have learned the hard way - and Jim Callaghan deserves the credit for being the first Prime Minister to have admitted it in so many words - that it simply isn't possible for a Government to spend its way to full employment. Indeed, if that were possible, the scourge of high unemployment would not be ravaging the whole of Europe today. For there is nothing easier for any Government than to spend more and borrow more.

The answer to unemployment is threefold - and it is the only answer.

First, to maintain sound financial conditions and low inflation.

Second, to remove obstacles to the efficient working of business and industry, so as to improve our economic performance and thereby economic growth.

And third, to do what we can to improve the working of the labour market in particular, so that trade unions are less likely to succeed in pricing their members out of jobs.

We have taken, and will continue to take, measures to assist on both these last two fronts, alongside the continuation of our policies for the first. And the benefits have already begun to appear.

Since the last election, some two years ago, the number of people in work in the UK has risen by around 650,000, while in the rest of the EEC taken together, it has continued to fall. If, at the time of the General Election, we had predicted this, I doubt if the people would have believed us. But the record now speaks for itself.

Why then has the registered unemployment total stayed so stubbornly high? Because we have been through a phase (it is still not over, though the most acute period has passed) in which the number of people of working age has been rising particularly fast, and within that total a higher proportion of married women have been seeking paid employment. So we have to run fast merely to stand still. Even so, it was encouraging to see a small fall in the registered unemployment total last month (a total, incidentally, which contains an unknown but almost certainly sizeable number of people who are not actually seeking work) - particularly since the measures to encourage jobs I announced in this year's Budget have not yet taken effect. All in all, it is far too early to be confident that the unemployment tide has turned. But the prospects for the second half of this Parliament are clearly better than they have been during the first half. And everything that Government can do, we are doing.

Over the past six years the British economy has been through a painful period of transition, and has emerged healthier and stronger. The figures tell their own story. Particularly the most recent ones. Since the last election manufacturing productivity has been rising at 4 per cent a year. Manufacturing output has been growing at 3 per cent a year - compared to less than ½ per cent a year under the last Labour Government.

Industrial profitability has been steadily rising - reversing the previous long-term downward trend - and capital investment is at an all-time high. And non-oil exports have risen since 1983 at some 8 per cent a year in real terms.

These are all signs of a healthy economy, and an economy on the move. But what of the future? What of the prospects for the rest of the Parliament?

I am as well aware as anyone that economic forecasting is a hazardous activity, particularly in a country so keenly affected by events in the outside world over which we can have little if any influence.

But provided the spectre of worldwide protectionism can be held at bay, I see no sign of a further world recession on the horizon. Certainly, the US economy has slowed down - but its previous growth rate was clearly unsustainable. And growth in the rest of the world is picking up. So even though overall world growth may well slow down a little, it seems set to continue at a reasonable pace.

If so, then the prospects for the rest of this Parliament will clearly depend pre-eminently on the success of our own endeavours.

In particular, we need to foster still further the elevation of the enterprise culture which is the true engine of growth and generator of jobs, by keeping firm control of overall public expenditure so that it continues to fall as a share of GDP, thus creating the headroom for progressive reductions in the burden of taxation.

Our record on public expenditure has been one of careful management, allowing increases where we believed it right to do so, and offsetting this by savings where savings could best and most sensibly be found. And among the increases have been a rise in capital expenditure on roads of around a quarter in real terms and an overall 22 per cent real terms increase in public sector repair and maintenance work since we first took office.

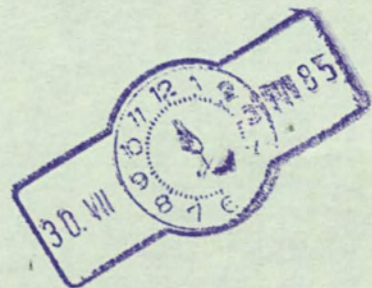
This overall restraint - never easy, but always necessary - has so far been required in order to cut back Government borrowing. In future, people should be able to see the fruits, at long last, in a lower burden of taxation - for those on whom that burden weighs heaviest, the manual worker in general and the lower paid in particular.

But lower taxation is only a part of the economic agenda for the second half of this Parliament. There is still more to be done to free the economy from some of the obstacles to growth - as well as the effects of our earlier measures in this direction still to come through. There is still much more to be done on the privatisation front: we have already transferred to the private sector one-fifth of the state sector of industry as it was when we took office in 1979, and by the end of this Parliament, with a privatisation programme that includes British Gas, I would expect that proportion to have doubled to two-fifths. And with the further progress on privatisation we can expect to see a further substantial growth in share ownership in general and employee share ownership in particular. Again, later this year I shall be bringing forward a Green Paper containing important proposals for the reform of personal taxation.

So there is a great deal going on. As indeed there should be. I understand the current concern about the high level of interest rates and - in some quarters - about its impact on the exchange rate. But interest rates have already come down significantly since the Budget, and will come down further as and when this is compatible with maintaining downward pressure on inflation. The struggle against inflation cannot and must not be compromised.

In short, the economy is in good shape. It is far healthier and more robust than the economy we inherited in 1979. It has made enormous strides since 1983. And it will continue to create more jobs - as long as we do not again make the mistake of the '60s and '70s and allow rising inflation, excessive public spending and high taxation to choke the new growth we have so carefully nurtured over these past six years.

NIGEL LAWSON



M. Butler

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

25 July 1985

Dear Secretary of State

I attach background notes on 'Economic Performance 1985', an updated version of an earlier note on 'the Government's record since 1979' and 'Public Expenditure and 'Cuts''. I hope you and other colleagues on the Economic and Social Group will be able to give them a wide circulation among your group of MPs so that they can make good use of them in presenting the Government's policies.

Yours sincerely
R Lawrence

PP WHITELAW
Approved by Lord Whitelaw
and signed in his absence

The Rt HonLeon Brittan QC MP

<u>ECONOMIC PERFORMANCE 1985</u>

<u>Gross Domestic Product</u> (GDP) at highest ever level. Despite the coal strike it grew by 2¾% in 1984. In 1985 OECD forecast we shall achieve fastest growth of any major EC country.

<u>Manufacturing output</u> rose by 3½% in 1984 - biggest percentage increase in any year since 1973.

<u>UK's productivity</u> for the whole economy improved by an average of 2¾% a year from 1980 to 1984, more than twice the rates achieved by France or Germany.

<u>Real Personal Disposable Income</u> was more than 2% higher in 1984 than in 1983.

<u>Industrial and commercial company</u> pre-tax profits (non-North Sea Oil) up almost 25% in 1984

<u>Manufacturing investment</u> rose by 14% in 1984. Investment in <u>construction</u> and <u>service</u> industries up by 12% over the same period to reach an all time high. <u>Business</u> investment in 1984 rose by 13% in real terms to reach an all time high.

<u>Overseas Trade</u> - 1984 fifth successive year of current account surplus. Invisible surplus an all time record of £4.3billion; non-oil export volumes up 9% in 1984 to reach an all time high (excluding erratic items).

<u>Manufacturing exports</u> grew by 10½% in 1984 - the biggest year-on-year increase since the early 1970s

<u>Inflation</u> - average through 1983 and 1984 was under 5% - the best performance since 1967 and 1968.

<u>Inward investment</u> Nearly 30,000 jobs created in 1984 as a result of inward investment - up 86% on 1983 figure.

<u>Employed Labour Force</u> - since March 1983 the number of people in work has increased by 614,000. UK has one of highest proportions (64% in 1983) of people in work amongst all the

major countries and is well above the European average.

Total fixed investment up by 7½% between 1983 and 1984 to reach an all time high (equivalent to around £55 billion at current prices).

Retail sales were up 4½% in three months to June compared with same period in 1984.

Net UK assets overseas estimated at £75 billion at end 1984 equivalent to around 23% of GDP - the highest percentage since 1945 and well up on 6½% in 1979.

JULY 1985

THE GOVERNMENT'S RECORD SINCE 1979

Economy

- Gross Domestic Product, at highest ever level has increased by 5%

- Real personal disposable income has increased by 7%

- Inflation has been halved

- Britain's overseas debt has been halved

Freedom and Enterprise

- 1.9 million more owner-occupiers

- Share ownership by employees and public greatly extended

- Self-employment up by half a million after falling for many years

- Number of businesses up by nearly 140,000

- Assisted places scheme now helping over 20,000 a year

- Radical extension of rights of trade unionists to secret ballot and restriction of closed shops

Infrastructure

- Spending on roads 30% higher in real terms, 493 miles of new national roads constructed; 45 by-passes completed; 148 by-passes planned

- Investment of £2.5 billion in the railways since 1979;

£1.5 billion in next three years

- Capital spending on NHS increased by a quarter in real terms; 157 health building schemes being planned, designed or under construction, including 46 new hospitals

- Investment by water authorities increasing by 20% over the next three years

Employment and Training

- Spending on training up from £380 million to £1.2 billion

- Youth Training Scheme launched and has benefited 730,000 young people - and extended next year to offer 2 years of training

- Community Programme launched and will help 230,000 people next year

- Number of adults trained under MSC programmes is being more than doubled to 250,000 in 1986/87

Privatisation

- 12 major companies transferred to private sector including 400,000 jobs

- Successful performance of privatised companies, eg Cable and Wireless, Amersham, National Freight Company and Jaguar

Taxation

- Thresholds up 20% in real terms having previously fallen

- Three taxes abolished: National Insurance Surcharge, investment incomes surcharge and development land tax

- Reduction in national insurance contributions worth £4bn to business

- Modifications to income tax worth £6 billion, or £260 a year to a married man on average earnings

National Health Service (NHS)

- Spending on NHS up 20% in real terms

- Waiting lists down 50,000 after rising 250,000 before 1979

- 57,600 more nurses; nearly 10,000 more doctors and dentists

- More patients treated each year: two-thirds of a million more in-patients; quarter of a million more day cases, 2½ million more out-patients each year

- Nurses pay up 32% in real terms by 1986

Social Security

- The retirement pension has gone up in real terms; so has child benefit; so has supplementary benefit; so have benefits for the sick and disabled

Education

- Expenditure per pupil has risen (16% primary, 8% secondary)

- Pupil/teacher ratio has fallen (from 18.7 to 17.9)

- More children into nursery education; more leavers into higher education

- Teachers average salaries up 9.4% in real terms

Housing

- Dwelling stock up 1 million

- Over 50% more homes renovated with grants than 1974-79

Law and Order

- Number of police officers increased by nearly 12,000; better paid and equipped

- Biggest prison building programme ever and number of prison officers increased by 2,700 with recruitment planned for further 4,000 staff by end 1988 (principally to man new establishments)

Bureaucracy/Controls

- Smallest Civil Service since the war (reduced by 130,000, saving £750m a year)
- Prices, incomes, exchange controls all off

- Development land tax and industrial and office development certificates abolished

- New arrangements to control regulation through Central Task Force

JULY 1985

BACKGROUND NOTE ON PUBLIC EXPENDITURE AND "CUTS"

Introduction

It is now being alleged that the Government is confused about its policy for public expenditure. This is nonsense.

The Government came to office saying - and I quote - "The State takes too much of the nation's income; its share must be steadily reduced."

It did so because it believed - and still believes - that people should be allowed to keep and spend as they wish more of the money they earn. There are millions who agree with this. Ask the 40% of pensioners who pay taxes, for example; or the nurses who pay £39 a week in stoppages.

The Government also believes that the country will benefit the less the State does and the more private companies and private individuals do for themselves.

This means public expenditure must be kept under control in the national interest. But doing this does not mean - and never has under this Government - cutting each and every item of spending. Like any sensible businessman or family it has priorities to some of which it allocates more and to others less.

Where there have been cuts

The Government has, in fact, cut public spending in some areas. To take one example, there are now 100,000 fewer civil servants than in 1979, saving £750m a year.

The Fontainebleau agreement is saving hundreds of millions of pounds a year in the UK's contribution to the European Community.

The Government has also cut spending on public housing because it believes that vast new council estates are no longer wanted or needed. And how right it is since 750,000 people have so far bought their council house homes and another 100,000 have applied to do so. People want to own their own homes and take pride in them instead of leading a regulated existence on often neglected council estates.

More Value for Money

There are other concrete ways of reducing public spending without affecting services.

One of them is getting rid of restrictive practices which are a well tried way of picking someone else's pocket.

Another is by improving efficiency more generally. Here the Government's Efficiency Unit has so far identified savings in central government worth £600m a year. Schemes to achieve two-thirds of this - £400m - have been accepted.

The independent Audit Commission is looking at value for money across the £29 billion of local authority spending in England and Wales. After looking at less than one-third of this they see potential for nearly £lbn a year of better value - £1 bn savings for the same services delivered or £lbn worth of better services for the same money.

The Government has also reduced public expenditure both by privatisation and by improving the finances (efficiency) of those industries which have not been privatised. National Bus, British Airports, British Airways, Shorts, Unipart, Rolls Royce, Royal Ordnance and British Gas are the next in line to join, among others, British Aerospace, National Freight, Cable and Wireless, Associated British Ports, Jaguar, Sealink and British Telecom in the private sector.

But What About Taxes?

So the Government remains unashamedly and unapologetically committed to reducing public expenditure, as a share of national income, and also to reducing direct taxes.

The Government has also cut direct taxes in at least four ways:

- at the top, former punitive levels have been cut to provide new incentives to managers;

- at the base rate from 33p to 30p in the £;

- at the lowest levels by raising tax thresholds 20% in real terms;

- so far as industry is concerned, by the elimination, for example, of the National Insurance Surcharge (not this Government's invention) worth £3000m - £3bn - a year.

The Government wants to reduce direct taxation further, not least because tax cuts help employment. But lower direct taxation will only be achieved - even with steady growth and greater efficiency - if public expenditure is kept under control.

Public expenditure has risen in certain areas because the Government planned it should - in Defence, in Law and Order, and in Social Security, where the Government has protected the pensioner, as it said it would.

Not surprisingly, it has risen because of the wholly unnecessary costs of the coal strike which the Government did not, of course, call and to which a third of the miners did not respond.

Public spending is also - again not surprisingly - taking a larger share of national income than planned because of the rise in this country (and across Europe) in unemployment.

<u>The Myths</u>
The Government does not object to a reputation for cutting public expenditure where it has done so as a matter of deliberate policy to eliminate waste. It takes due pride in this achievement. But it objects to claims that it has cut it where it hasn't.

There are a lot of myths around:

- First, there are those who say that spending has been cut when what they really mean is that it has been increased by less than they were demanding.

- Second, there are those who invent "facts" in spite of the evidence. For example, in the National Health Service which has in fact expanded not contracted.

Since 1979:

- spending on the NHS is 20% up in real terms

- we have 57,000 more nurses and midwives and 9,600 more doctors and dentists

- more patients are being treated - over 3m more outpatient attendances and over 750,000 more in-patient cases treated

- waiting lists have been reduced, notwithstanding the strike in 1982.

Some cuts!
Then take education. Spending on schools has been reduced,

but nothing like so fast as pupil numbers have fallen. In January 1979 there were 18.9 pupils to every teacher. Five years later it was 17.9 pupils per teacher - the best ratio ever. Over the same five years spending per pupil rose by 15% in real terms - again to a record level.

It may however be asked "Why have some schools suffered cuts?" That question should be put to your local council. The fact is that as pupil numbers have been falling too many councils have been wasting money maintaining half empty schools and in the process retaining teacher posts where they are no longer needed.

There is still substantial scope for savings on things which do not affect the quality of education but do burden the ratepayer. In particular, the need for greater efficiency in school catering, cleaning and caretaking is well established.

Finally, there are those who say that Britain is going to rack and ruin, regardless of the evidence.

What are the facts?

Well, apart from total investment in the whole economy being at a record of £55,000m - £55bn - this is what has happened in the public sector since 1979:

- spending on national roads is up 22% in real terms

- spending on major motorway repairs is up more than 50% in real terms

- capital spending on the NHS is up 20% in real terms.

And more in real terms is being spent on our railways and on our water and sewage services.

Summary

Thus, what the Government is trying to do is to control public expenditure in the national interest. Within the overall total it allocates spending according to its priorities.

The Government's aim is to make sure that the country lives within its means; does not preempt money which industry needs to expand; does not borrow too much; and finances the borrowing it has to do in a non-inflationary way without leading to excessive interest rates.

Sensible management of public expenditure is essential. We have seen what happens when public expenditure gets out of hand (1976, IMF and all that). That is why the Government will continue to manage sensibly.

JULY 1985

From: The Rt. Hon. Francis Pym, M.C. M.P.

House of Commons,
London, SW1A OAA

23rd July, 1985.

23 JUL 1985
Mr Odling-Smee
CST FST EST MST
Sir P Middleton
Sir T Burns
Mr G White
Mr Wicks Mr Love
Mr Cropper
Mr H Davies
Mr Culpin

Dear Nigel,

Thank you for your letter of the 15th July.

We are glad to note how broadly you are in agreement with us about priorities and objectives. In particular, we welcome your assurance that you do not regard unemployment as a necessary consequence of the battle against inflation and that you agree that unemployment is our major social problem.

We share your view of the need for wage restraint since a reduction in the level of real wages relative to the cost of capital will eventually translate itself into more jobs. This is, indeed, one of the reasons why we attach so much importance to sustained capital investment programmes, (and not just a once-for-all upturn due to a change in capital allowances in a particular financial year). However, a reduction in real wages, even if attainable, takes a long time to work its way through the economy and more urgent action is needed if unemployment levels are to start falling soon.

The figure we quoted in our last letter for the average level of assumed earnings of those re-entering the work-force was necessarily illustrative (because no one can be sure what it would be and the Treasury has tended to underestimate future wage rises in the past) but we do not feel that this weakens the general thrust of our argument about the large revenue losses arising from high unemployment. We are glad to note your assurance that the Treasury takes this argument into consideration in determining its advice to you and we hope that you will give greater weight to it in your future public statements.

We would counsel you not to underestimate the second-round effects of public investment. The dramatic fall in the numbers of unemployed in the U.S.A. in recent years, which appeared to surprise some of your advisers in the Treasury, showed how great and progressive an impact these effects can have. American experience also disproves your contention that a reduction in unemployment cannot be the result of additional public expenditure or increased borrowing.

....

We are frankly puzzled by your strictures about "easing up on monetary conditions" at a time when Sterling M3 seems to be almost out of control and bank credit has expanded so rapidly. We favour a tight monetary policy combined with a more flexible fiscal policy.

It is not an expansion of the Money Supply but of the PSBR which is needed. Some among us have long maintained that there is no direct relationship between the PSBR and interest rates. Your own policies have demonstrated this fact anew. After all, the UK has one of the lowest PSBR's in the industrialised world but our interest rates are almost double those of our competitors.

We believe that increased levels of public investment are vital. They can be achieved without irresponsibility over the PSBR. Every pound received from privatisation can, and in our view should, be used to back a concerted strategy for employment, without adverse effect on the PSBR. Such a strategy would include capital investment in such areas as housing, roads and infrastructure generally.

We believe that this would have a beneficial effect on the levels of employment and provide the starting point for that virtuous economic circle to which we referred in our previous letter and which can alone ensure both falling unemployment and the prospect of a continuing regime of tax reductions in the future.

It is our intention to publish this exchange of correspondence.

I am copying this letter to the Chief Whip.

Alan Haselhurst

The Rt. Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer,
The Treasury,
Whitehall,
London,
S.W.1.

cc PS/CST
PS/FST
PS/EST
PS/MST
Sir P Middleton
Mr Wicks
Mr Cropper
Mr Lord
Mr H Davies
Sir T Burns
Mr Odling-Smee
Mr G White

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

15 July 1985

The Rt. Hon. Francis Pym MC MP
House of Commons
LONDON
SW1

Dear Francis

THE COST OF UNEMPLOYMENT

Thank you for your letter of 10 July.

I can assure you that I do not accept that unemployment is a necessary consequence of the battle against inflation or of success in reducing public expenditure. It is perfectly possible for inflation, public expenditure, and unemployment to fall together. Indeed low inflation and control of public expenditure make it more likely that unemployment will fall. But success against unemployment also requires other changes, especially among wage bargainers, so that the steady growth in demand we are experiencing is increasingly translated into more jobs.

I do not accept the charge that the Treasury's estimates of the public expenditure cost of unemployment are misleading because they do not include the revenue losses associated with unemployment. The Treasury makes it quite clear when calculations refer to expenditure alone. It has never denied that there may also be a revenue effect, but there is no single measure of it and it is misleading to suggest otherwise.

The revenue calculations you quote assume a hypothetical world in which the unemployed somewhat implausibly find jobs at average wages despite the high proportion of unskilled labour among the unemployed. They also assume that all this happens at no extra cost to the government. It therefore follows that the reduction in unemployment you are considering cannot be the result of additional public expenditure or increased borrowing (with its effect on the level of debt interest).

If you are worried that the Treasury neglects offsetting savings, let me assure you that when we examine proposals for increased public sector capital investment we make full allowance for offsetting savings in expenditure on unemployment and supplementary benefits and any increased tax revenues. In addition we also make allowance for any second-round effects on both the economy and the Exchequer. However, it must be said that these second round effects on output and employment are unlikely to be significant unless one is prepared to take risks with inflation by simultaneously easing up on monetary conditions, in which case any employment gains would be short lived.

I agree that unemployment is the major social problem facing the country today. But the calculations that you present are not relevant to the solution of the problem. It can only be solved by maintaining a stable, responsible financial framework that permits economic expansion and rising employment while at the same time working to improve the performance of the economy and to encourage the private sector to take advantage of the opportunities that exist.

I am sending a copy of this to the Chief Whip.

NIGEL LAWSON

Sir T Burns

The Chancellor has slightly amended the reply to Mr Pym. Pl cd you confirm you are content — today pl?

AWK
15/7

Ch/ Letter below for sign. with one amendment from Sir T. Burns ("ⓧ")
AWK

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

15 July 1985

The Rt. Hon. Francis Pym MC MP
House of Commons
LONDON
SW1

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I am sending a copy of this to the Chief Whip.

NIGEL LAWSON

From: J ODLING-SMEE
11th July 1985

SIR TERENCE BURNS

cc Mr G White

LETTER FROM PYM

I attach a draft reply to this. I also attach a background note by Mr White containing some comments on Sinfield's article and on our own attitude to cost of unemployment calculations.

J ODLING-SMEE

244/7/52

Draft Reply to Pym and Haselhurst

The Cost of Unemployment

Thank you for your letter of 10th July.

I can assure you that I do not accept that unemployment is a necessary consequence of the battle against inflation or of success in reducing public expenditure. It is perfectly possible for inflation, public expenditure, and unemployment to fall together. Indeed low inflation and control of public expenditure make it more likely that unemployment will fall. But success against unemployment also requires other changes, especially among wage bargainers, so that the increased demand we are experiencing is increasingly translated into more jobs.

I do not accept the charge that the Treasury's estimates of the public expenditure cost of unemployment are misleading because they do not include the revenue losses associated with unemployment. The Treasury makes it quite clear when calculations refer to expenditure alone. It has never denied that there may also be a revenue effect, but there is no single measure of it and it is misleading to suggest otherwise.

The revenue calculations you quote assume a hypothetical world in which the unemployed find jobs at average wages despite the high proportion of unskilled labour among the unemployed, at no extra cost to the government. It therefore follows that the reduction in unemployment you are considering cannot be the result of additional public expenditure, tax cuts or involve higher interest rates and hence debt interest.

Yet you appear to be suggesting that there is an easy way to finance tax cuts or expenditure increases through a reduction in unemployment. But the indisputable fact is that higher public expenditure costs money, even after taking account of higher revenues and lower expenditure on unemployment and supplementary benefits. Calculations of the cost of unemployment cannot alter that. And the higher PSBR would make it more difficult to reduce interest rates and encourage private sector investment. The net effect on output and employment of such a policy would not be great unless you were prepared to take risks with inflation by easing monetary policy, in which case the employment gains would be short-lived.

If you are worried that ~~we are neglecting~~ offsetting savings, let me assure you that when we examine proposals for increased public sector capital investment we make full allowance for offsetting savings in expenditure on unemployment and supplementary benefits and any increased tax revenues. In addition we also make allowance for any second-round effects on both the economy and the Exchequer.

I agree that unemployment is the major social problem facing the country today. But the calculations that you present are not relevant to the solution of the problem. It can only be solved by maintaining a stable, responsible financial framework that permits economic expansion and rising employment while at the same time working to improve the performance of the economy and to encourage the private sector to take advantage of the opportunities that exist.

THE COSTS OF UNEMPLOYMENT: BACKGROUND NOTE

1. A number of references have been made in the media and in Ministerial cases to the calculations Professor Sinfield of Edinburgh University has made of the costs of unemployment.

Sinfield's calculation

2. Sinfield's methodology is broadly in line with that used in the 1981 EPR article:-

(a) benefits to the unemployed (UB, SB and housing benefit) for Great Britain, which Sinfield then revises upwards to include Northern Ireland and men over sixty who are no longer required to register;

(b) redundancy fund payments - not included in the 1981 article, but would have been included in the (withdrawn) 1982 update;

(c) direct tax and NIC losses: Sinfield appears to include an estimate for revenue lost from the unregistered unemployed and discouraged workers. The 1981 article also made an allowance for this. Sinfield uses the same (23%) figure for the average tax rate used in the 1981 article. The subsequent rule changes bringing about the taxation of benefits to the unemployed mean that this figure is no longer correct. Sinfield also uses the EPR assumptions to calculate NICs foregone;

(d) indirect tax losses: the 1981 article did not include this calculation (the 1982 update did). Sinfield's calculation follows DE and MSC studies on the consumption behaviour of the unemployed, with an assumption of a 20% rate of tax.

(e) the 1981 calculation also made an allowance for increased administrative costs -not relevant for Sinfield's calculation of the overall cost.

Comment

3. In 1981, the Treasury produced a calculation of the Exchequer cost of an increase of 100 000 in unemployment from the private sector in an Economic Progress Report

article. An update, with some methodological changes, was prepared in 1982, but the then Chancellor agreed that publication would not be appropriate.

4. In the first instance, this was because the original article had been misinterpreted. The cost of an extra 100 000 was, on several occasions, 'grossed up' to produce a spurious figure for the total cost of unemployment. It was also considered potentially misleading to put together the cost of benefits actually paid out with some necessarily notional figure for revenue foregone, which depended upon a large number of assumptions. Moreover, the figure for benefits paid out, in the '100 000 extra' case, is also notional, since it is affected by the cause of the rise (increased inflow or increased duration).

5. Secondly, by the time that the 1982 update was prepared, severe doubt had been thrown on the meaningfulness of the exercise, since it had been demonstrated that the cost of unemployment could vary substantially, depending on the assumed cause (macro simulations are available that demonstrate this). It was therefore decided to cease carrying out calculations for anything other than the cost of benefits paid out.

6. The standard line on Parliamentary Questions on this issue is to quote the appropriate benefits figure but to note that revenue foregone estimates would be misleading because they depend on assumptions about the causes of unemployment.

3.76

FROM: MRS R LOMAX
DATE: 10 July 1985

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Wicks
Mr Cropper
Mr Lord
Mr H Davies

SIR T BURNS

LETTER FROM MR FRANCIS PYM

The Chancellor would be grateful for a quick and forceful riposte to the attached letter from Mr Francis Pym. He has commented that it is clearly the handiwork of your former protege Mr Shields.

RACHEL LOMAX

From: The Rt. Hon. Francis Pym, M.C. M.P.

House of Commons,
London, SW1A OAA

10th July, 1985.

Dear Nigel,

The cost of Unemployment

You may be aware that Conservative Centre Forward is addressing the unemployment problem as one of its priorities. We are sure that the Government shares our view that unemployment is the major social problem facing the country today. We fear, however, that you may accept that a high level of unemployment is one of the painful and necessary consequences of the continuing battle against inflation, and part of the price the nation must pay if we are successfully to reduce public expenditure.

Such a serious judgement can only be reached, if at all, after the most careful study of the true net cost to the Exchequer of providing for the people who are out of work. We are deeply concerned lest no such calculation may have been made by the Government. Not only has no such official research been published, but there has been a consistent refusal by the Treasury to acknowledge the value of independent research in this field or even when pressed to give figures in reply to specific parliamentary questions.

The impression conveyed by such an attitude can only be damaging to a Government preoccupied with public expenditure, especially when a number of reputable committees, individuals and public bodies have produced their assessment of the true cost of unemployment. In 1981, the Manpower Services Commission estimated it at £12.45 billion; in 1982 the House of Lords Select Committee concluded that it was £15 billion; by 1985, Professor Adrian Sinfield and Mr. Neil Fraser of the University of Edinburgh have estimated that it has risen to approximately £20 billion.

The basis of such calculations can be summarised as follows:

With three million unemployed the cost of long-term and short-term supplementary benefit and unemployment benefit is about £7.3 billion in the current financial year (according to your own estimates).

...

If these three million were to find employment at the average wage of a little over £187 per week the net gain to the Exchequer from increased income tax, VAT returns and National Insurance contributions would be approximately £11.95 billion in a full financial year. So we calculate the real cost of unemployment at a level of three million to be £19.25 billion.

If two of these three million could be found productive work the net revenue gain to the Exchequer would be approximately £7.8 billion at present levels of taxation. This would be sufficient to cut the basic rate of income tax by 7p in the £ at no cost to the PSBR. Alternatively, this increase in revenue could be used to abolish the PSBR.

Even if only one million of the unemployment were to find work, the Exchequer gain would be around £3.7 billion, sufficient to reduce the basic rate of income tax by more than 3p in the £ or halve the PBSR.

Furthermore, it should be emphasised that these calculations represent simple first-round effects and ignore any subsequent dynamic benefits to either the economy or the Exchequer.

We feel strongly that a realistic discussion of the economy can only be based on the assumptions we have set out and not on mis-leading assertions that the cost of unemployment is only about one-third of its true level.

We are convinced that the economy can only move into a virtuous circle of rising employment, rising tax revenues and falling tax rates if aided, in the first place, by a stimulation of public sector capital investment. If the tax cuts are made first, their effect on the level of unemployment will be negligible and the opportunity for subsequent and more far-reaching tax cuts will be lost.

We would be grateful for your views.

I am sending a copy of this to the Chief Whip.

(HASELHURST)

The Rt. Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer,
The Treasury,
Whitehall,
S.W.1.

009/106

Treasury Chambers, Parliament Street, SW1P 3AG

Bernard Ingham Esq
Private Secretary
10 Downing Street
London
SW1

18 July 1985

Dear Bernard

MINISTERIAL GROUP ON THE PRESENTATION OF ECONOMIC AND SOCIAL POLICY: THE GOVERNMENT'S PUBLIC EXPENDITURE RECORD

At its meeting on 10 July, Lord Whitelaw's group commissioned a note on the government's public expenditure record. The Chief Secretary has approved the enclosed note for circulation to Backbench groups.

The Chief Secretary will incidentally be meeting his group of MPs on Monday, 22 July. Unless you see any difficulties he proposes to hand out the note to his group then.

I am copying this letter to Andrew Turnbull and to Joan MacNaughton (Lord Whitelaw's Office).

Yours sincerely

Richard Broadbent

R J BROADBENT
Private Secretary

001/114

PUBLIC EXPENDITURE:
THE GOVERNMENT'S RECORD

Control of public expenditure is a key element in the government's economic policies.

2 The government's objective is to hold public spending broadly stable in real terms. No more, no less. So that as the economy grows, public spending falls as a proportion of national income.

3 It is this that makes it possible for government to reduce the burden of tax while keeping public sector borrowing down.

4 What has the government achieved?

5 As a proportion of national income, the public expenditure planning total has fallen every year since 1981-82 (leaving aside the exceptional costs of the coal strike last year). This year the total is expected to be 41½ per cent of GDP compared to 43½ per cent in 1981-82.

6 Over the same period, the PSBR has been reduced from 3.3 per cent of national income to a forecast 2 per cent in the current year. At the same time the government has succeeded in raising income tax thresholds by 29 per cent in real terms since then.

7 Not dramatic figures, perhaps. But steady, well-managed progress. A consistency which contrast sharply with the damaging ups and downs of the 1970s. A consistency which the government means to stay with.

8 But what has this consistent approach meant in practice since 1979?

9 It has meant a bit more where it was needed. 8,500 more doctors, for example, 48,000 more nurses. 5 per cent more in real terms for pensioners, £473 more for each child at school. 37 per cent more on law and order. 29 per cent more on defence.

10 And this has been balanced by a bit less where we think it is not needed. Less support for big loss makers (British Leyland received no aid this year compared to £175 million in 1978-79). Less council house building, more private ownership (over 800,000 council houses sold). Lower net contributions to EC institutions(£91 million less than in 1979-80).

11 And it means achieving better value for money. Getting more for each £ of taxpayers' money. Cutting out bureaucracy. Since 1979, Civil Service numbers have fallen by 133,000 saving about £750 million.

12 In other words, a sensible balance of priorities within a controlled total. Proper account being taken of changing needs and changing priorities. Getting more out of what we put in. Not "slashing expenditure". Not "a free for all". No boom and bust. But disciplined self-restraint within a controlled total.

13 That is what is required of any responsible government.

PRIME MINISTER 10 July 1985

STATE OF THE ECONOMY

Inflation

High interest rates are beginning to have an effect. Sterling has remained very strong; tight money has triumphed over oil prices. World commodity prices are continuing to decline. The strength of the pound is lowering the price of imported materials. The latest wholesale price figures are quite encouraging. There is even some evidence that house price increases are slackening off. Building societies are lending less money now than a year ago in money terms; and their liquidity ratio has fallen from 19.6% in the first quarter of 1984 to 17.1% in May 1985. The narrow money figures remain under good control.

Bank Credit

There is now a nice judgment to be made about inflation. The wider money aggregates continue to show very rapid growth. Bank lending to the energy sector is up 40% on a year ago; to other financial institutions (excluding banks) up 30%; and even manufacturing industry is borrowing 15.5% more. Lending to building societies has been especially buoyant, as their ordinary deposit base has been squeezed and so they have switched to wholesale funds from money markets.

Credit advanced to other financial institutions has risen from £12.2 billion in February 1984 to £16.8 billion in May 1985. Within this, the building societies in May 1985 hit the staggering annual growth rate of 105% in the amount they were borrowing from the banks; insurance companies and pension funds hit a growth rate of 40%; and leasing operations 35%. This reflects the tail end of the investment boom after the Corporation Tax changes. (De Zoete figures)

Money Policy

This credit is not yet having any dramatic impact on price increases. But if left unchecked, it could at any point trigger a major increase in spending power in the economy, which could have inflationary consequences.

The judgment is now, therefore, a nice one. The CBI is desperate to see rates down, and will soon also be complaining about the strength of the pound affecting its export business. But there are risks in going for too early a decline in interest rates.

an early reduction of ½ per cent, presented as caution, may still be consistent with this.

The political cycle suggests running a tight money policy for a bit longer. It would be nice to be sure that inflation had been seen off over the next few months as a result of a stronger pound and a sharp correction to inflationary expectations - which were getting out of hand in the early part of this year. There would still be plenty

of time to get interest rates down, with a consequential beneficial impact on mortgage rates; and to administer a bigger stimulus to output in the 1986-87 run-up period to the General Election. Too rapid action now through fear of administering too sharp a shock to the economy might leave you in the position where, too close to an Election, you had to administer corrective action yet again - which would be far more damaging.

The Public Sector Accounts

As always, there are problems. The public sector pay bill, and cost inflation in the public sector, were underestimated in the previous White Paper, and so many departments are faced with making real cuts in order to adhere to the guidelines. Revenues will be considerably lower from oil than forecast at Budget time. Each 1% rise in the dollar/sterling rate loses approximately £150 million to the Treasury. On this basis, we are already more than £2 bn. down. The public thinks the Government is deliberately starving the health and education services of cash, and more money will doubtless be needed to do some kind of deal on standards and contracts with teachers, and to finance the Health Service so that it can absorb the ever-increasing number of patients. The road programme, too, is popular and is thought to be under-resourced. These are bids which should be considered favourably.

But there remains much to be done on the other side of the equation. It would be fatal to give way on public spending targets at this juncture of the Parliament. The U-turn rhetoric will grow louder, and economic management will become more difficult. There is no substitute for refusing to sign the cheques for the large nationalised industry overruns. Coal, rail, steel have to be dealt with firmly now. The structural problems - particularly in coal - have to be faced up to. The administrative overhead and public sector assets have to be reduced and pillaged yet again, as the Chancellor is suggesting in his memo.

But it needs good follow-up to make sure that it happens this time. The local authority settlement has to be kept within reasonable bounds. And defence spending - largely through pressure for greater efficiency and better buying - has to be brought down. The asset sales money is being offered in the negotiation very early. Some of it may be needed to cover higher public spending; but some is also needed for tax cuts. Although this will be criticised as a sleight of hand, this Government can claim - with good reason - that asset sales will be a continuing part of its programme, stretching well into the future. Could you make the Chancellor's gift of asset sales conditional on good behaviour from departments? Can't any be used for tax cuts?

Will Growth Continue?

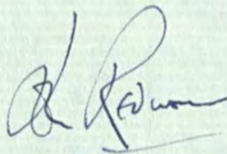
The main hope of growth continuing into 1986 and 1987 is from keeping up the pressure against inflation. It looks as if pay increases are going to remain quite high - 5-6% for settlements, 7-8% for earnings. If inflation is brought down by continuing with the policy you are currently following, then this will leave scope for a considerable increase in real disposable income, and in consumer spending - the dominant part of the economy anyway. You should expect there to be less stimulus to growth from investment as a result of the end of the capital investment boom on the back of tax changes; and some slowing of export growth as a result of the stronger exchange rate policy now being pursued. Growth can continue, but at a more modest rate than will be recorded in 1985, where it will be given a substantial boost by the ending of the miners' dispute.

Unemployment

Whilst most of the outlook is therefore reasonable - on prices, output, consumer spending and real incomes - on this same basis, unemployment still looks unpromising.

It is therefore imperative that a further attack is made on the Why Work? problem. This means taking more people out of tax entirely; examining a tax amnesty to persuade people out of the black economy into the white; and further investi-

gation of benefit claimants. This autumn is the last time to take bold action on unemployment, and your deliberations over the next few weeks should make sure that colleagues are fully aware of the seriousness of the problem.



JOHN REDWOOD

R7.91 **SECRET**

covering note
cc ECON POL: Public Exp
Pt 32

6

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

2 July 1985

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

I attach drafts of the two papers for the Cabinet discussion of public expenditure on 11 July: the Chancellor's paper on economic prospects and the Chief Secretary's paper on the Survey. I am also enclosing a draft of the Chief Secretary's memorandum for the E(A) discussion of the review of nationalised industries investment and financing.

See ECON POL Public Exp Pt 32.

The Prime Minister will have an opportunity to discuss these papers with the Chancellor and Chief Secretary at her 5.30pm meeting tomorrow. She may also have views on the timing of the E(A) discussion of the nationalised industries IFR. Possible meeting dates this year are 10 and 17 July. In the past the position of nationalised industries has usually been discussed a day or two before Cabinet. In view of the difficult background set out in the E(A) paper, there may be some advantage this year in delaying the E(A) meeting until after Cabinet has discussed the aggregate figures.

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

5,000 [already spent
salaries
[illegible]
[illegible] 3,000] 2.

(1A)

ECONOMIC PROSPECTS PAPER FOR CABINET

The short term prospects for the economy are broadly similar to those foreseen at Budget time. The temporary rise in inflation has gone slightly further than was then envisaged and output is rather more buoyant. But the inflation rate is still expected to subside in the second half of the year and 1986 should see continued growth and significant progress towards lower inflation. The main risks overseas, as ever, concern developments in the US economy and the oil market. At home they concern the upward drift in earnings and the pressures which will arise if we fail to hold expenditure to its present plans.

The world

2. The major 7 economies are likely to grow at around 3% this year and next, with inflation averaging about 4%. World trade - on a UK trade weighted basis - may increase more slowly than the 7-8% achieved in 1984; about 5-6% this year and next. Some overseas markets of importance to the UK (particularly the oil producers) are expected to reduce their imports.

3. In the US, there has been little real progress on the federal deficit. But though output growth has slowed down, domestic demand is still reasonably strong. A lower dollar is likely. The US current account deficit seems likely to persist and there are dangers from the growth of protectionist pressure.

4. The world oil market remains in a fragile state. Some fall in the world price seems likely, and a sharp fall a possibility.

The British Economy

5. At home the prospects continue to look reasonably good. We have now embarked on our fifth year of continuous growth in national output, and can look forward with some confidence to a sixth. Boosted by the rebound after the coal strike, output should rise by 3½ per cent this year and perhaps by a further

2½ per cent in 1986. This would be a commendable performance, bearing in mind that North Sea output is likely to start falling next year.

6. The expansion is broadly based. Real personal disposable incomes should grow by 2½-3% this year, resulting in rising personal spending. This could be faster next year as inflation falls.

7. Company profits have recovered substantially. The 1984 rate of return for industrial and commercial companies (excluding North Sea oil) was as good as at any time since 1973. (If oil is included, it was the highest since records began in 1960.) Business fixed investment is likely to remain strong in 1985 and should rise further in 1986. But there have been further economies in stockholding in the first quarter of this year. Overall, domestic demand may rise by 2% in 1985. Exports of goods and services seem to be more than holding their share of world trade and are expected to rise by 8%, after 7% growth last year. In 1986 the balance might change to 3% growth in both domestic demand and exports.

8. The recent increase in the RPI is expected to be temporary but the peak (probably in July) will be about 1% higher than was forecast at Budget time. The recovery in the exchange rate since February this year, and the prospect of a steadier, and perhaps falling, mortgage rate will result in lower inflation probably from August onwards, falling to under 5% this time next year.

9. A continuing high level of pay settlements makes progress on employment more difficult. It does not look as though there will be any decline in private sector settlements in the coming pay round. Indeed, there is some risk of a further increase. So although the forecast assumes continued tough bargaining in the public sector with public service earnings rising more slowly than in the private sector, pressures for closer parity with those in the private sector will undoubtedly increase.

10. Against this background, the prospects for unemployment are uncertain. Total employment is estimated to have risen by 600,000 between March 1983 and December 1984. This rise is more than accounted for by increases in part-time employment and self-employment. The number of full-time males in jobs fell. And as many of the new jobs have also been taken by new entrants to the labour force, unemployment has continued to rise, at an underlying rate of perhaps 10,000 to 15,000 a month. The unemployment statistics may overstate the number of people looking for jobs; a considerable proportion of the claimants who have been unemployed for a year or more are not actively seeking work. But, although the employment measures announced in the Budget have not yet had time to make any significant impact, the fact that demographic changes will add ½% to the labour force over the next two years means that a substantial drop in the unemployment count is unlikely.

11. Turning to the financial picture, the extreme nervousness in the financial markets at the turn of the year has been overcome. But there is no scope for relaxation. Experience early this year shows that the credibility of policy cannot be taken for granted. We must continue to demonstrate to a world in which most major countries have lower inflation than us, that we are determined to maintain sound financial policies and that they are consistent with bringing inflation back to a downward trend.

12. Despite some fall in North Sea oil revenues, we remain on track for the £7 billion PSBR set for 1985-86 at the time of the Budget. But to avoid any overrun on borrowing (and hence upward pressure on interest rates) we must ensure that we keep to our spending plans, both in the current and future financial years. The Chief Secretary's paper makes clear that the pressures for higher public spending remain intense. It will require great determination to maintain the firm control of expenditure which is central to our economic strategy and essential if we are to maintain any prospect of reducing the tax burden.

13. A summary of the most recent Treasury forecast is in the attached table.

Conclusion

14. In most respects, the economy is doing well. Output and employment are rising, though unemployment is not yet on a downward trend. Inflation is set to resume its decline. But there are dangers. We may have to be in a position to withstand a sharp change in the dollar, or the oil price. And we have a good way to go to match the inflation performance of our more successful competitors. At home, we face upward pressure on earnings growth with the consequent problems for employment. We must not add to these hazards by allowing public expenditure to increase beyond our plans.

15. The burden of taxation and national insurance contributions is still substantially higher than it was in 1978-79, despite a small reduction in the last Budget. Further progress towards reducing the tax burden must be made, both for the sake of employment and to maintain political credibility. If we are to secure those reductions it is essential that we agree to the Chief Secretary's proposals for the Survey. I urge my colleagues to do so.

Mr Turnbull

NDPM
AT 24/6

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

24 June 1985

Dear Leon

I attach a background note on 'Inflation, Pay and Jobs'. I hope you and other colleagues on the Economic and Social Group will be able to give it a wide circulation among your group of MPs so that they can make good use of it in presenting the Government's policies.

Yours

Willie

The Rt Hon Leon Brittan QC MP

BACKROUND NOTE

INFLATION, PAY AND JOBS

The British economy is entering its fifth successive year of economic growth after the deepest recession since the Second World War.

If we are to nurture the recovery, we need to keep the closest possible watch on two numbers - the rates of increase in inflation and our unit wage costs - and to do everything possible to slow down their rise.

The first priority is to hold down - and drive down - inflation. Recent increases in the rate of price rises to 7% this month are a reminder that inflation is not beaten yet. But the rise is temporary. Producers' output prices are rising slightly less fast than a year ago, and this month has also brought encouragement with the smallest rise (3.6%) for four years in raw material prices paid by our manufacturers.

All this bears out the Government's prediction that retail price inflation will fall appreciably from 7% in the second half of this year: a prediction supported by most outside forecasters. The Government's financial policies will ensure that, just as they have brought inflation down from a peak of over 20% in 1980.

But the outlook for jobs depends on the behaviour of pay bargainers. If they try - and succeed in - using the present hump in inflation to raise pay demands they will be directly damaging the prospects not only of those currently out of work, but also those whose jobs they are trying to make better paid.

Why?

This is because, unless matched by better efficiency, pay increases merely add to costs and so impair our chances of winning orders.

This leads on to the second number we must keep under the closest scrutiny - the rate of increase in unit wage costs, or put another way, the cost in each factory of producing a particular product.

Here again, as with inflation, our performance on unit cost increases is a long way out line with our competitors'.

Over the last three months they were up 6.4% on a year earlier - double the increase seen at this time last year. Yet the unit wage costs of our competitors have been rising either very little or even falling.

In 1984, unit wage costs actually fell by 1% in West Germany and the USA, and by 4.5% in Japan.

This is the clearest possible warning of the risks we are running in Britain of pricing British goods out of foreign markets.

Both today's inflation rate and the rate of increase in unit wage costs are too high and must be brought down.

And pay bargainers, who are only too ready to blame the Government for unemployment, must recognise - and the workers whose jobs depend on what they do must make them recognise - that they have a direct responsibility for the level of unemployment.

Efficiency and competitiveness in industry and commerce are the key to jobs, for they are the key to sustaining economic growth. So what is needed today is realism and restraint by pay bargainers who accept and acknowledge the contribution they have to make to keeping people in work and to getting more people now out of work into productive jobs.

The Sampson Letter

18th June 1985
No. 19

A fortnightly report on world politics and finance

Europe's new challenge: the view from Paris

France is now more than ever the key piece in the Western jigsaw of politics and technology, as President Mitterand pits his own Eureka programme as the civilian rival (or parallel?) to Reagan's Star Wars.

But how seriously worked out are the French proposals? Last week I was in Paris talking to French government experts and advisers. I came back more convinced that there is a real movement towards closer co-operation - which should show itself at the Milan summit on June 28 - from which no major technological company can afford to stay aloof.

The outward political signs, it is true, are not too hopeful. Mitterand is disenchanted with Kohl, particularly since he used the veto to protect cereal prices a month ago. The Americans' tactless diplomacy over Star Wars threatens to divide Europeans further. The football massacre in Brussels has hardly improved the spirit of Europe - least of all in Britain.

But there is some hope in Paris that Mrs Thatcher - partly because of 'Britain's shame' - will lean over backwards at Milan to show herself a good European. And Mitterand, whatever his other setbacks, is still staking his reputation on forging closer European unity - particularly in technology.

HOW THEY FOUND EUREKA

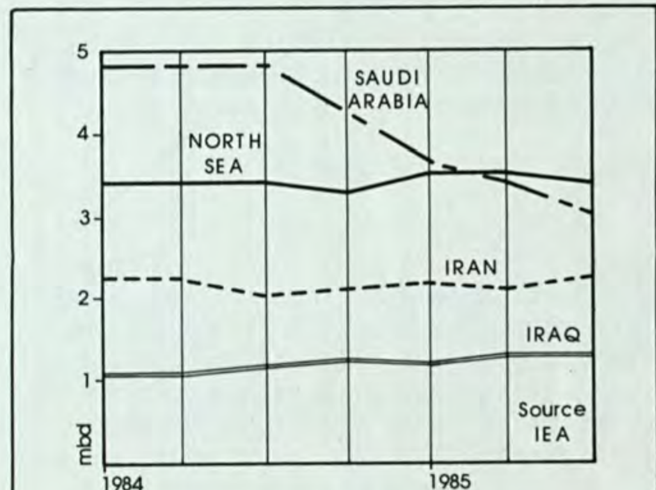
The French commitment to Eureka still looks rather vague. But it is more thought-through than it looks to others. As one of Mitterand's advisers put it to me last week:

We had the idea of Eureka in January, at a sherpa meeting before the Bonn summit. It was suddenly clear that the Americans had their own Star Wars project, MITI in Japan had its programme, and Europe had nothing. Then we consulted companies, and realised that they were waiting for governments to lead.

European co-operation in high-tech today is like the European coal and steel community - and later Euratom - in the fifties. Why did Britain stay out then?

The French were determined to see Star Wars as a challenge to which Europe must respond: the word défi runs through their memos. Another of the President's aides reported in a note on March 25:

'Europe indirectly finances Star Wars research; by the movement of capital towards the US it makes good the budget deficit and the greed (boulimie) of the



THIS LETTER looks at the implications of the growing oil-glut, to which the North Sea now contributes more than Saudi Arabia (p.6)

It also includes:

* *Lt-Gen Abrahamson on Star Wars research in Europe (p.3)*
* *Basil de Ferranti on European protection (p.8)*
* *Reports from Brunei on the Sultan and Harrods (p.4)*
* *Malaysia and the Russian chocolate-eaters (p.4)*

ANTHONY SAMPSON

Treasury.. the leitmotiv of the US Congress is how to make Europe pay for this defence effort.'

But Europe, the note continued, should have the means to do something on its own - even though France and Germany spend only $29b on research and development, compared to $110b spent by the US.

When Mitterand proclaimed the Eureka plan at the Bonn summit in March it still sounded very vague. But (one adviser said), 'We could have made it less vague. We did prepare a thorough 500-page document in typically French style. But we wanted to leave the discussion open to other countries'.

Over the following weeks an inter-ministerial team has been meeting in Paris every Saturday to firm up the proposals. A government memo on Eureka, dated May 1, stressed the need for agreed objectives before broaching the 'vast palette of scientific knowledge'. It described Eureka as being made up of:

* a political commitment to master the technologies of the future.
* an improvement and reorientation of the existing R & D programmes.
* a pragmatic application of agreed programmes.
* a policy of stimulating innovation by opening up markets, fiscal incentives and measures in specific sectors.

EUROPE VERSUS THE COMMUNITY?

How far can Eureka provide a real push to technological unity in Europe? The British (see my last Letter) have been sceptical that the French are being bureaucratic and étatiste, and that they will never open up their own government contracts - least of all in telecom - to foreigners.

But the French strongly deny this. 'We don't want Eureka to be bureaucratic', said one aide. 'It should be a go-between (you remember the film?). And we did offer to open up telecom bidding reciprocally with Britain: it was Plessey which refused to let foreigners break into their market.'

And both the French and British agree that they must not link technological plans too closely to the European Community, whose President Jacques Delors (rather embarrassingly) will put forward his own plans for technology at the Milan Summit in two weeks' time.

Mitterand's team want to keep Eureka away from the Community. As one of them said: 'We can't have every member including the Irish and the Greeks insisting on their own share - le juste retour. We want to include Sweden, Switzerland and others.'

And Mrs Thatcher is very wary of EEC projects like ISPRA or CERN, and of the EEC research budget which has just doubled. She dreads companies leaning on government subsidies. She wants to keep research co-operation as informal as possible, with a top committee of officials - including Sir Robin Nicholson, the chief scientific adviser who is much in play - to short-cut bureaucracies.

Star Wars, in the meantime, has the huge attraction to techno-companies, even in France, of offering funds. Most French aerospace chiefs, including Henri Martre of Aerospatiale, have carefully kept their distance from Washington, knowing their dependence on French government.

But the President of the succesful aerospace company Matra, Jean-Luc Lagardere, said last week that it was already in contact with the Americans, and that it had sufficient areas of excellence to collaborate as equals. He said it was 'inept' to set Eureka against Star Wars. 'We must be pragmatic, and not play toreadors'.

The British accept that Star Wars research will go ahead, but they now have more reservations. The minister of defence Michael Heseltine is becoming more overtly anti-American - fuelled by his dislike of Cap Weinberger.

Mrs Thatcher remains loyal to Washington; but she has become more interested in Eureka. And her advisers are worried that the advanced computer systems developed for Star Wars, which will remain very secretive (see Abrahamson opposite), will give IBM and the other Americans a still longer lead.

LAST-REEL DIPLOMACY

And many European governments in NATO share the same fears about Reagan's sentimental rhetoric and approach to Star Wars - the 'last-reel diplomacy' of a President who is waiting for the final happy ending against the sunset.

There remain many obstacles in the way of Eureka. However successful the 'go-betweens' they are unlikely to achieve any real direction or push (it seems to me) without major government funding.

Many Europeans, including some high-tech leaders (like Philip Hughes of Logica - see my last Letter), hope that Eureka can respond to social challenges to technology - in health, education or communications - to counterbalance the defence challenge. But new breakthroughs in computing are unlikely to happen without pressure from major contracts.

The French, British and Germans are still a long way from agreeing, and from breaking away from their own bureaucratic constraints; while Star Wars is setting a faster pace for collaboration in a different direction.

But I believe nevertheless that the challenge of Star Wars will provoke a constructive European response, in which even the French and British - in spite of their ancient rivalries - will collaborate.

The French want big systems

'French companies are looking for big projects with high stakes', says Albert Bressand, the French diplomat who runs the research project Promethée, analysing what's wrong with Europe:

They know - even Dassault - that they've run out of projects on their own. But they don't like the idea of isolated research that's implied in Star Wars: they want systems, not bits of systems, which can make Eureka into a bargaining-counter with the Americans. They don't want to be sous-traitants - though the American word subcontractor may sound better.

They're worried about the secrecy of working for Americans. There's a danger that the politicising in Star Wars will infect other industries - including the Community's Esprit programme.

The French too often see programmes in terms of their own production. That was why the government didn't use Apple computers, which were the most suited for children, for French schools. The priority should have been to spread consumption of computers, but they turned it into helping French production. The Europeans must be on the leading edge of consumption, like the Japanese.

Star Wars and secrecy

The chief of the Star Wars research in Washington, Lieut-Gen Jim Abrahamson, flew to London for two days last week (Pan Am economy class) to report to American ambassadors in Europe. I asked him whether he was worried by the European complaints that Star Wars would fragment them and encourage a brain drain:

No, I'm not worried - it's part of a process of debate and explanation. We're not trying to take bunches of scientists over to the US: in fact it's just the opposite, US scientists will be going over to Europe, and some may well stay there.

We're looking for brilliant teams of creative people who can take a portion of technology and push it forward in a constructive way. We hope there will be European teams who can take a leadership position, and can use research for their own interests - including applying the technology to conventional military battles.

NATO didn't really refuse to endorse Star Wars at their Lisbon meeting. It was like forgetting to say to your wife 'I love you today, baby'.

We all should have the same interest in protecting sensitive technology and preventing an illegal and improper technical flow to the East. That not only erodes our own advantage, but costs money to make up for the erosion. Well over half the research in the US is unclassified. Command and control systems, with their complex computer software, are probably the most highly protected.

The key to any restrictions is the mutual decision about sensitivity. The people who get the main benefit from the research are the teams who are creating knowledge, who know what they're doing. If the US pays for the research it has the right to use it without paying royalties; but that doesn't stop the team applying it to military projects in their own country.

Defense research pushes civilian technology forward in a dramatic way, as it did with micro-wave ovens. Sensors are already being used to help paraplegics walk. It's hogwash to suggest that space research can't be applied to civilian uses.

People and pointers

THE SULTAN OF HARRODS

Can a billion-dollar business remain indefinitely with no visible owner? The extraordinary story of Harrods and its British department stores is now taking a new twist.

Three months ago, after visiting Brunei, I first revealed that the real owner of Harrods was almost certainly not the Egyptian Al-Fayed family, but the Sultan of Brunei for whom they acted as agents. Now the Sultan's ownership is widely assumed: 'The Bruneians all assume it', says a friend just returned from Brunei 'and they're proud of it'.

But the saga has a new episode; for it has become clear that the Sultan has now virtually disowned Mohamed Al-Fayed. Having first asked the British government to give Al-Fayed VIP treatment - including highly-prized privileges at airports - he has since withdrawn the request.

The Sultan has apparently turned against Al-Fayed (as he earlier turned against his previous financial adviser Adnan Khashoggi, Al-Fayed's ex-brother-in-law) - partly because of his handling of the Harrods bid. Thus Harrods is left with no evident link with its owner - except through a secret guarantee to a Lichtenstein bank.

And the Sultan himself is now, according to my Brunei sources, behaving rather oddly. He has missed polo-games; he is growing a beard; Khashoggi has been back to Brunei.

There have been open rifts between the Sultan and his father, the much more austere previous Sultan: they have been praying at different mosques. Mrs Thatcher's visit to Brunei two months ago was uneasy: the Sultan was thought to be upset that she did not curtsey.

This month the Sultan was supposed to receive an honorary degree at the American College in Paris, which his representative in London would have accepted for him; but the Sultan cancelled it - without telling the college.

The British government is in an embarrassing position over Harrods, having first stopped Tiny Rowland from buying it, and then allowed the Al-Fayeds to. (Though Rowland has since behaved so badly, by trying to smear the Al-Fayeds in his paper The Observer, that he has spoilt his own case).

Kleinwort's, who negotiated the Harrods deal, are still more embarrassed - having stated firmly that 'there is no hidden hand' behind the Al-Fayeds, which few people can now believe. There are rumours that senior heads will soon roll at Kleinwort's; and that their blunder cost them the lucrative business of privatising British Gas, which last week went to Rothschilds instead.

Where will this odd story end? There is no obvious reason why the Sultan should not openly own Harrods, as he owns the Dorchester hotel. But to keep such a major financial asset in limbo will only embarrass everyone in the end.

OPEC, NIGERIA AND PRIVATE JETTIES

Professor Tam David-West, the Nigerian oil minister, is acquiring a reputation for speeches of refreshing candour - which are all the more interesting in view of Nigeria's pivotal position in OPEC.

In a recent outburst in Jos (reproduced in the current OPEC Bulletin) he enlivened his audience by explaining:

Quick-money devices are often resorted to by quite a good number of Nigerians. Illegal oil deals, illegal bunkering, smuggling, unauthorised crude oil allocations, fronting, conmen, etc, all conspire to disrupt and even destroy the economy.

Other negative factors in the economy were the 'Private Jetty Culture' - about 200 of these existed during the last civilian administration, most of them depots for smuggling and illegal deals especially in oil - the 'Container Culture' and the 'Commission Culture'... Unless and until we resolve these contradictions in our daily lives, Nigeria will continue to be a moral cripple and an economic invalid.

David-West concluded by attacking critics who suggest that Nigeria should leave OPEC altogether, to produce as much oil as it wants. It would, he said, be 'clearly a desperate or panic action'. Nigeria anyway could not produce much more than 2 million barrels a day; and OPEC could team up to price Nigeria out of the market. He went on:

I have often likened such a situation to the withdrawal of a person from membership of a Secret Society. Once in, it is advisable to stay in, even if not-so-happy. Because the maverick members could be eliminated 'in the interests' of the Organization.

A number of leading OPEC countries could easily unleash such an attack since their production price per barrel is very low. We must not forget for one moment that we are OPEC's weakest link.

BROKEN CROCKERY?

Chester Crocker, the urbane diplomat in charge of Africa at the State Department, was in London last week, quietly defending his policy of 'constructive engagement' towards South Africa.

He insists that his policy is still essential, despite Pretoria's apparent bad faith with Washington in both Mozambique and Angola, where rebel armies are now clearly supported from South Africa.

It is not a question, he says, of trusting South Africa or anyone else - 'trust is a matter for family members, or lovers' - but of dealing with the real forces in the region.

But the next few weeks may reveal more about the real forces, or their limitations. June 16 marks the anniversary of the Soweto uprising in Johannesburg nine years ago; and later this month the African National Congress will hold a major conference in Tanzania to discuss future strategy in South Africa. Its new slogan is 'Make South Africa Ungovernable' - a prospect which looks ominously imminent now that several black townships are virtually no-go areas.

The militancy of Congress raises a new question for Crocker - and for the British Foreign Office. Does constructive engagement extend to engaging with the black leadership - including Mandela?

Commodities and Countries

WAITING FOR RUSSIAN CHOCOLATE

On top of Africa's other commodity problems come the troubles of cocoa. Not only is an imminent cocoa glut in West Africa pushing down prices; but Malaysia threatens to by-pass Africa altogether by huge plantings of cocoa - as it has already done with oil palm.

It is partly the familiar pattern, like sugar or copper, of too much production, too little consumption. The cocoa lobby has had some success: the Japanese are taking to cocoa-drinking, and chocolate is increasingly being sold to the West as a high-energy sports food, with Mars (for instance) sponsoring the London Marathon.

But the West still seems almost saturated with chocolate, and developing countries are not very keen - partly because it melts in the heat.

Next month the producers will meet to try, once again, to stabilise prices in the International Cocoa Organisation. But neither the US (the biggest consumer) nor Ivory Coast (the biggest producer) belong to it; and there are no funds for buffer-stocks.

World consumption looks like declining through 1985, and the producers look longingly towards the Russians who have an almost unlimited appetite for chocolate - if they can afford it.

Top Cocoa Producers ('000 tonnes raw)

	1974/75	1979/80	1984/85
Ivory Coast	242	379	505
Brazil	273	294	396
Ghana	377	285	170
Nigeria	214	169	150
Cameroun	118	124	114
Malaysia	13	32	100
Ecuador	78	98	80

Source: Gill & Duffus

The oil-slide: how it hits Saudis, Britons or Texans

The oil-price, as this Letter has repeatedly warned, is now feeling the full strain of the summer slump. The two weeks until the next OPEC meeting on June 30 will be very tense.

'There's nothing to suggest that OPEC can coalesce, even round a lower number' reports a well-placed informant in the British National Oil Corporation (soon to be disbanded). 'It's hard to imagine what can reverse the downward drift. The IEA figures for world demand look bad enough - and they are always over-optimistic, as the oil companies which supply them admit'.

OPEC is becoming more obviously worried. King Fahd has made clear that Saudi Arabia won't tolerate more cheating (without actually mentioning Nigeria). 'It's one thing to be the swing producer' as one oilman put it: 'it's another to look like an idiot'.

Yamani repeats his threats of a price-war in retaliation. But it's hard to imagine the Saudis actually risking making drastic price-cuts while demand is so slack.

In the meantime Iran is reported to be discounting by $4 a barrel, and Iraq is pushing ahead with its pipeline - which should be pumping at least another 200,000 barrels a day by October, and perhaps half a million next year.

And for the last month (see front page box) the North Sea has been producing more than Saudi Arabia - an apparent economic absurdity. The British will produce about 200,000 barrels a day less during maintenance-work in the summer, but this does not reflect any deliberate cut-back.

OPEC members are both angry and baffled by Britain's all-out production. 'Won't it seem rather foolish when the oil is running out in the 'nineties?', asked a Nigerian diplomat. 'Is it part of a conspiracy to push the price down?'

WILL IT REVIVE EUROPE?

Certainly with all this high production and low demand, the surprise is that the price is not falling still faster. 'It shows that the market is still very imperfect and inefficient' says the London oil consultant Joe Roeber of Roeber Associates.

And the falling price produces its own kinks in the graph. 'It's rather like money at a time of high inflation' as George Soros of the Quantum Fund points out: 'when oil is going down, no-one wants to be holding too much - which produces temporary shortages'.

But the downward trend, I believe, will still continue, and the debate is hotting up as to how that will affect the ailing economies of the West.

There's little doubt that a lower oil-price will stimulate European industry, while offsetting the inflationary fears which so worry the Germans and British. In a rigorous survey in the current Amex Bank Review my colleague Richard O'Brien is very bearish about oil, and shows how 'the oil-price is now threatening to break through a significant long run trend line'. He concludes:

Even if real interest rates stay unchanged, a fall in inflation due to lower oil prices would pull down interest rates, further helping corporate cash flows. Given the present slowdown in the US economic expansion, and the increasing reliance on Europe to keep recovery going, a fall in European oil prices would be particularly timely.

But I still have a major reservation about the benefit to Europe. For the fact is that it was higher oil prices which stimulated Japanese technology after 1979, forcing companies to push up exports to pay for the oil.

If the Europeans enter a new era of cheap oil, they could well relax their already inadequate technological effort still further, becoming still less competitive with Japan and the US.

OIL, POUNDS AND DOLLARS

And for the British the falling oil-price is bound to be worrying, just when the pound looks better-placed against the dollar. For whatever the cheap-oilers may say about providing more jobs, the loss of oil revenues would be more serious for sterling than the gain to manufacturers.

'For the time being the high interest-rates in Britain are neutralising the falling oil-price', says Richard Dale of Rothschild's: 'but the effects of interest-rates can wear off. The markets tend to think of only one factor at a time. For a time people were worrying about Britain being a one-commodity country. Now they've forgotten oil for a bit. But if the price takes a real knock the oil factor will be back with a vengeance.'

The consequences for the US are obviously more complex, since bad news for Texas is good news for the East Coast. But the news from Texas will be very bad if the price falls below $23 or $22; and insiders in Texan banks report serious worries about the prospect of oil and Mexico going down together.

At present Washington has no intention of introducing import tariffs, even if the oil-price sinks suddenly. And certainly the Texan lobby is not what it was.

But a fall below $23 would seriously affect new oil-drilling, and bring new shocks to the banking system. And the pressure to introduce tariffs - from bankers, oil companies and Texans - would (I suspect) become irresistible.

An import tariff would make much sense for Americans - not least in helping to finance the deficit. But it would do nothing to stem the downward drift of the oil-price in the rest of the world - and might well accelerate it.

Latin America: the outward flow and debtor-power

The new round of brinkmanship between Argentina and the IMF has once again reminded bankers of the fragility of their debt agreements in Latin America.

In the meantime the political implications are deepening. I have received this letter from Stephany Griffith-Jones, the Chilean economist at the Institute of Development Studies:

Dear Anthony,

The fundamental fact remains that the Latin American continent has since 1982 been a net exporter of financial resources - particularly to the US.

Between 1982 and 1984 the net transfer averaged approximately US $25b annually - around 25% of the region's total exports of goods and services. Negative net transfers have not only curtailed present Latin American growth, but also endangered future growth by a sharp decline in investment levels. According to the recent report of the Inter-American Development Bank the ratio of investment declined from 26% of GNP in 1981 to 20% in 1983.

But it has not been fully understood that negative transfers also cause a shift in the bargaining position between creditors and debtors. When funds flow into a developing country, the greater bargaining strength lies in the lenders, who must ultimately decide to transfer funds and can impose their conditions.

But when the net funds flow outwards, the debtor government has potentially the greater bargaining strength, as it must decide to repay and ultimately to transfer the funds. The debtor can not only resist the conditions of the lender, but can impose his own.

It would seem an attractive option for large Latin American debtor governments to refuse to make transfers over, say, three to five years - which would reduce their servicing of the debt to the same levels as new inflows of capital. It would not imply a default but be postponing debt-servicing till feasible.

Such a measure could be made consistent with some proposals, such as interest capping, which are being discussed amongst central and private bankers in industrial countries. It could avoid major disruptions of the banking system.

Undoubtedly it would require some additional public funds from industrial countries, but they would be small in relation to the potential cost of an outright default. And more rapid growth in Latin America would clearly benefit exporters in industrial countries, and in the long-term the banks themselves.

Such a proposal may seem perhaps too radical. However, last year's Commonwealth Report on the Debt Crisis, chaired by Lord Lever, insisted that any satisfactory solution must urgently 'put an end to the premature outflows of resources from developing countries'. More surprisingly 'Business Latin America' - representing the largest multinational companies in the continent - has recently followed a similar line.

But only the debtors can transform general discussions into policy action.

Yours sincerely,

Stephany Griffith-Jones

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Is the European Community going more protectionist?

Developing countries are increasingly worried that the European Community is extending its protectionism beyond simple tariffs, with the help of its 'New Commercial Instrument'.

But another viewpoint is expressed in this letter I have received from Basil de Ferranti, the chairman of the Ferranti computer company who is also a (Conservative) Member of the European Parliament.

Dear Anthony,

I believe the New Commercial Instrument marked a breakthrough in deciding what goods to allow into the Community. It effectively extended Community preference into the non-tariff area.

The original cornerstone achievement of the EEC was the common external tariff which enabled member states to remove their internal tariffs, and established the principle of Community preference. However, all of us sordidly engaged in trade know only too well that tariffs have long since ceased to be an effective protectionist device. All countries use differing technical standards, testing procedures, safety laws and blatantly nationalistic purchasing policies to protect their faltering and probably incompetent firms from the challenge of competition.

The New Commercial Instrument, agreed by the European Council last December, provides the framework for member states to decide jointly whether goods from outside should be allowed into the Community market, or excluded for not meeting technical specifications, for dumping or unfair trading practices.

This could enable the whole Community to make foolish decisions to protect its own industries. But it does allow the Community to play a common negotiating hand to persuade other countries - which all have comparable arrangements - to reduce their non-tariff trade barriers.

The New Commercial Instrument now gives the Community real clout; but the conventional wisdom in Brussels pretends that it does not exist, in order to avoid frightening the world - particularly the Third World - into believing that the Community has gone protectionist.

This is a wholly mistaken policy. We should be proclaiming that the Community is determined to use its commercial clout to reduce trade barriers throughout the world.

Yours ever,

BASIL DE FERRANTI

Japan, Owen and Africa

Can part of Japan's surplus be effectively deployed by providing credit to Africa? David Owen, leader of the British SDP, sent me a bold proposal he put to the Japanese in Tokyo this month - which develops the ideas of the International Commission on Humanitarian Issues (he is a member) in the book Famine:

Although your aid budget is large, if one looks at aid plus defence spending Japan falls to the bottom of the league table of western democracies as a proportion of GNP. Japan cannot expect to have its aid programme assessed by its major trading partners without taking into account your low defence spending...

I would propose that Japan establishes a Japanese Credit Bank for Africa. It would work through small African community groups and voluntary agencies to provide concessional soft credit to the farmer. It would also have to establish links with the national banking structure in Africa.

Repayments on loans would be ploughed straight back into the African countryside. As the loans would have soft easy repayment schedules, this is an aid scheme. It is not in any way profit making. It requires that knowledge be built up of the client communities. This would provide marvellous opportunities for young Japanese staff to learn about African societies.

Although there are existing credit schemes in Africa, they have only limited success. The real pioneering work has so far been done in Asian rural communities. So no doubt there is already a reservoir of knowledge about such schemes in Japanese aid circles ...

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020 250/054

Prime Minister ②

To note

AT 10/6

AT

Treasury Chambers, Parliament Street, SWIP 3AG

Andrew Turnbull Esq
10 Downing Street
LONDON SW1A

10 June 1985

Dear Andrew,

NATIONAL SAVINGS: INDEX-LINKED ISSUES

The current series of index-linked Certificates, Retirement Issue and Second Index-Linked Issue (RI and 2IL), have become increasingly complex over the years with the accretion of quinquennial bonuses and annual supplements. This makes them complicated to administer and difficult for customers to understand. Now is a convenient time to tidy up this situation. The Economic Secretary has decided, with the Chancellor's agreement, that 2IL shall be withdrawn and replaced on 1 July with a new Third Issue Index-Linked Certificate (3IL).

The 3IL will be much like a conventional fixed interest Certificate with a 5-year maturity except that the return will be made up of indexing plus a guaranteed real return of 3½ per cent. This return, which will be raked to provided an incentive for investors to hold it to maturity, is equivalent to the yield on a 5-year gilt.

The market for indexed instruments is fairly small, so 3IL is not expected to attract a large volume of savings, and should not worry the building societies who do not themselves offer indexed investments. Since this is simply a tidying up operation it should not give any wrong signal about inflation expectations.

The intention is if possible to announce the launch of 3IL, together with the next annual 3 per cent supplement on 2IL, on Tuesday 11 June.

Yours ever,

Adrian Ellis

ADRIAN ELLIS
PRIVATE SECRETARY

Reference...

COVERING CONFIDENTIAL UNTIL 11.30 ON MONDAY 10 JUNE 1985

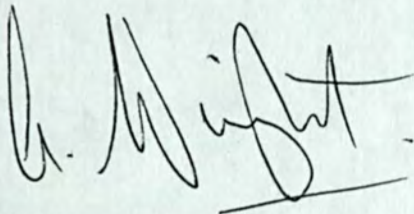
Mr Ash	BSO
Mr Norton	BSO
Mr Jones	BSO
Mr Flint	BSO
Mr H Liesner	Ch Econ Adv DTI
Mr Harvey	S1 DTI
Miss Lea	EC2A DTI
Miss Silver	Inf DTI
Mr Wilson	Inf DTI
Sir Terence Burns	HMT
Mr Collins	HMT
Dr Rowlatt	HMT
Mr Gilhooly	HMT
Mr Monaghan	HMT
Mr Folger	HMT
Mr Vernon	HMT
Mr Evans	HMT
Mr Dolphin	HMT
Mr Beedell	CSO
Mr Hawkins	MAFF
Mr Hargreaves	D Emp
Dr Boothroyd	D En
Mr Tan	D En
Mr P O'Brien	BOE
Mr Turnbull	PMO
Miss Roche	PMO

Prime Minister (2)
Good news on input prices. The rate of increase has been as high as 9 per cent only a few months ago
AT 6/6

DRAFT PPI PRESS NOTICE FOR MAY

I attach the draft PPI Press Notice for May, to be published on Monday 10 June 1985.

Any comments should reach me by noon Thursday 6 June.



A D Wright
PPI
Room 2.202
Business Statistics Office
(GTN) 2068 2584

5 June 1985

CODE 18-77

HP 4/83

FILE

DA

10 DOWNING STREET

From the Private Secretary 11 June 1985

NATIONAL SAVINGS: INDEX-LINKED ISSUES

The Prime Minister has seen and noted the proposal to introduce a new Third Issue Index-Linked Certificate.

(Andrew Turnbull)

Adrian Ellis, Esq.,
HM Treasury.

250/054

Prime Minister (2)

To note

AT 10/6

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10 Downing Street
LONDON SW1A

10 June 1985

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Adrian Ellis

ADRIAN ELLIS
PRIVATE SECRETARY

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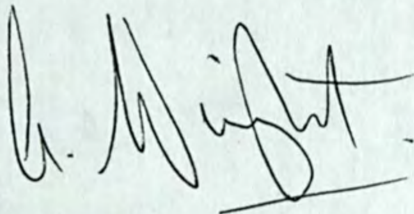


A D Wright
PPI
Room 2.202
Business Statistics Office
(GTN) 2068 2584

5 June 1985

CODE 18-77
HP 4/83

Press Notice

Department of Trade and Industry

CONFIDENTIAL UNTIL 11-30 AM ON

MONDAY 10 JUNE 1985

1 Victoria Street, SW1H OET Press Office: 01-215
Out of hours: 01-215 7877

Ref: 354

Calls other than press and broadcast to 0633 56111 Ext 2584

PRODUCER PRICES FOR MAY 1985

OUTPUT PRICES

The movement in the price index for home sales of manufactured products measured over a twelve-month period showed little change in May at 5.6 per cent as compared with 5.7 per cent in April. Between April and May the index rose by 0.2 per cent.

The increase in the index for manufactured products other than food, drink and tobacco measured over a twelve-month period showed little change in May at 6.4 per cent as compared with 6.5 per cent in April. Between April and May the index rose by 0.3 per cent.

The movement in the index for the products of the food, drink and tobacco industries over a twelve-month period rose to 4.6 per cent in May from 4.4 per cent in April. Between April and May the index rose by 0.3 per cent.

INPUT PRICES

The increase in the index for materials and fuel purchased by manufacturing industry measured over a twelve-month period fell to 3.6 per cent in May from a revised figure of 5.2 per cent in April. Between April and May the index fell by 1.1 per cent. More than one-half of the fall between April and May was attributable to lower prices for food materials.

The movement in the index for materials purchased by manufacturing industry other than the food, drink and tobacco industries over a twelve-month period fell to 6.5 per cent in May from 8.2 per cent in April. Between April and May the index fell by 0.6 per cent.

The index for materials purchased by the food manufacturing industries fell by 1.2 per cent over the twelve months ended May, following an increase of 0.4 per cent over the twelve months ended April. Between April and May the index fell by 1.6 per cent.

prepared by the Government Statistical Service

1980 = 100

	1984 MAY	1985 FEB	MAR	APRp	MAYp
OUTPUT PRICES (HOME SALES)					
All manufactured products	132.1	136.6	137.5p	139.2	139.5
Products of manufacturing industries other than food, drink and tobacco industries	127.4	133.3p	134.2p	135.1	135.5
Products of food, drink and tobacco industries	139.3	141.5	142.5	145.3	145.7
INPUT PRICES (MATERIALS AND FUEL)					
Materials and fuel purchased by manufacturing industry	134.5	147.6	145.5	140.8	139.3
Materials	133.1	139.9	140.1	137.7	136.0
Fuel	139.5	173.9	163.8	151.5	150.4
Materials and fuel purchased by manufacturing industry other than the food, drink and tobacco industries	133.3	154.4	150.7	143.4	142.4
Materials	130.3	145.0r	144.5	139.6	138.8
Fuel	138.9	173.4	163.1	151.0	149.8
Materials and fuel purchased by the food, drink and tobacco industries	133.0	135.2	135.4	134.9	133.2

p = provisional

r = revised

NOTES

1. The indices relate to the average prices for a month. The full effect of a price change occurring part-way through any one month will only be reflected in the index for the following month.

2. Scheduled prices for petroleum products have been used as components of the input price index rather than the prices actually charged, which are not readily available.

3. All indices for the latest two months are provisional. Indices for earlier months are provisional where indicated in the tables.

COVERING CONFIDENTIAL
until 23.01 hours 30 May
then UNCLASSIFIED

File

FROM: K VERNON
DATE: 30 May 1984

1. MR EVANS This is generally helpful HPE 30/5
2. MR PAGE

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Unwin
Mr Anson
Mr Cassell
Mr Odling-Smee
Mr Battishill
Mr Fitchew
Mr Lavelle
Mr Scholar
Mr Riley
Mr Shields
Mr Mowl
Mr Davies
Mr Culpin
Mr S Davies
Mr Folger o.r.
Mr Matthews
Mr Mowl
Mr Riley
Mr Allum
Mr Graham
Mr Pickering
Mr Spencer
Mr Walton
Mr Webb
Mr Salveson (for No. 10)
Mr Cropper
Mr H Davies
Mr Lord
JB/01

OECD ECONOMIC OUTLOOK, JUNE 1985

The outlook will be published at 23.01 hours on Thursday 30 May. We therefore expect to see press comment on Friday 31 May.

2. I attach two separate notes by EB, and EF2 covering sections on UK prospects, and world economic developments and prospects.

3. The section on the UK contains a generally accurate and uncontroversial statement of policy and the 'prospects' do not differ markedly from the Budget forecasts. Helpful statements are:-

(a) On the durability of the recovery:- "The growth of GDP in 1984 of 2½ per cent at a time when the miners' dispute was reducing output by over 1 per cent indicates the resilience of the present recovery."

(b) On growth in 1985:- "Output in 1985 will also have been affected by the dispute but growth may still turn out to be over 3 per cent." The forecast implies that in 1985 the UK will top the EC growth league as it did in 1983.

(c) On inflation:- "After rising a little in the first two quarters of 1985, the increase in consumer prices is expected to slow down in 1986."

(d) On employment:- "The recovery has generated a substantial increase in new jobs."

4. However, the OECD express concern about the risks to recovery from the upward pressure on earnings:- "stronger upward pressure on earnings...could lead to less employment growth and more unemployment than projected."

5. On the world economy in general the OECD are reasonally optmistic:- "The economic situation and outlook are favourable in a number of key respects."

6. The introduction stresses the importance of supply side policies "If vigorous and credible policies are taken to make the European economies more flexible, to strengthen incentives, and to improve the functioning of markets, this might also contribute to a restoration of business confidence and a revitalisation of the "animal spirits" upon which the dynamism of market economies ultimately depends." Such a statement can be interpreted as one of approval for current UK policies to improve the supply side of the economy.

K Vernon

K VERNON

UK FORECAST

OECD forecast of 3¼ per cent <u>GDP growth</u> in 1985 is just below the 3½ per cent Budget forecast. OECD expect growth to continue into 1986 at a reduced rate of 2-2½ per cent - reflecting reductions in North Sea oil production.

2. <u>Employment</u> expected to grow at 1 per cent a year but "little likelihood of significant reduction in unemployment. Report points to risks of "stronger upward pressure on earnings as the recovery continues. This could lead to less employment growth."

3. Consumer prices inflation "after rising a little in the first three quarters of 1985...is expected to slow down to around 5 per cent in 1986". This is a little above the budget forecast of 4½ per cent <u>RPI inflation</u> to the second quarter of 1986.

4. <u>Current balance</u> is projected at a surplus of £1¼bn in 1985 - below the £3bn of the Budget forecast - increasing to £1¾ bn in 1986. These balances are above those forecast in the last Economic Outlook.

Points to make

Positive

5. (i) Report sees output growth continuing 3¼ per cent this year and 2½ per cent in 1986 - similar to Budget forecast.

(ii) Inflation forecast to fall to around 5 per cent in 1986

(iii) Employment expected to grow at 1 per cent this year.

(iv) UK topped EC growth league in 1983 and, despite the coal strike, was around EC average in 1984. For 1985 the OECD forecast we shall again grow faster than any EC country.

Defensive

(i) <u>OECD say</u> "little likelihood of any significant reduction in unemployment". OECD however forecast large increases in real wages in 1985 - and report notes that "stronger upward pressure on earnings could lead to....more unemployment".

Source: EB.

OECD ECONOMIC OUTLOOK : JUNE 1985

WORLD PROSPECTS

The OECD's summer forecast to end-1986 has changed little from the picture presented last December. OECD inflation could now be a little higher and the rise in European unemployment slightly lower than earlier expected. The forecasts for OECD growth and world trade have not changed significantly.

2. Output growth in the OECD is put at 3¼ per cent this year and 2¾ per cent next. Surprisingly US growth at 3¼ per cent this year is higher than the December forecast - though this reflects the Secretariat's unduly pessimistic earlier assessment and the fact that the current forecast was finalised before the latest downward GNP revisions. European activity is forecast to increase at 2¼ per cent at an annual rate over the forecast period.

3. OECD unemployment has fallen slightly since 1983 as a result of US performance and is expected to level out at 8½ per cent from now on though the number of European jobless continues to edge up. Despite rising employment, continuing labour force growth means the unemployment total for the OECD area could continue to rise reaching 31½ million by the second half of 1986.

4. The Secretariat forecasts earnings growth in manufacturing will flatten out at around 5 per cent both this year and next. The Outlook notes the changed wage setting behaviour in US and to a more limited extent elsewhere. But unit labour costs are expected to pick up a little as productivity gains slow though commodity prices are likely to remain weak. Consumer price inflation in Europe is projected to fall slightly to 7 per cent next year though with US inflation more or less stable, the OECD rate remains at 4¾ per cent both this year and next.

5. World trade growth is forecast to slow by almost half this year to 5¼ per cent with a similar rate of growth in 1986. The OECD current account position continues to be dominated by the rising US current account deficit which the Secretariat puts at $145 billion next year. The Japanese surplus is seen rising to $50 billion by the end of 1986. Outside OECD the NODC's current account deficit could worsen a little over the forecast period while OPEC continues to run a small deficit.

Policies

6. Despite a reasonably favourable outlook the Secretariat draws attention to the disappointing unemployment performance in many countries and identifies a number of features that threaten growth prospects:

- high budget deficits in the US and elsewhere
- high intrest rates
- volatile exchange rates
- dollar appreciation and the associated current account imbalances
- trade tensions
- the fragile financial position of developing countries.

7. As usual the OECD's policy recommendations are hedged - but no emphasis is put on achieving further reductions in inflation. Improving supply performance by reducing structural rigidities is wholly endorsed. The editorial's argument that in the past policy makers have eschewed macro-policies to raise demand because of inadequate supply response is contentious. It leads on to the suggestion that if structural policies succeed in significantly improving the supply side there could then be a case for easing demand policies.

8. Discussion of the unsustainable US fiscal and external position and the associated dollar interest and exchange rate risks feature prominently and include the possibilities of a 'hard' or 'soft' landing for the dollar. Cuts in the US Federal deficit are regarded as essential but the Secretariat argues that on unchanged policies this could exert a contractionary influence on activity in the US and elsewhere. They argue that in Europe at least the gains from lower interest rates would be insufficient to offset the depressing effects on output from slower US growth and reduced US imports.

9. In the Secretariat's view this calls for complementary policy measures by others outside the US including action on the monetary and fiscal side. Japan is urged to encourage import growth and to provide more attractive yen assets though their macro-policies are not addressed. Elsewhere the Secretariat recommends, with Germany and perhaps the UK foremost in mind, that

> '...in countries where inflation and budget deficits have been brought under control, yet growth is too slow and unemployment too high, attention could usefully be paid to measures, such as appropriately designed tax cuts... to improve supply potential <u>and</u> to provide some support to demand'

10. The OECD acknowledge the risks this might entail to inflation and budgetary positions but clearly regards them as manageable.

<u>LINE TO TAKE</u>

11. OECD's latest economic projections for the major countries support the FSBR forecast for slower but still buoyant growth with no pick up in inflation in the period ahead. Welcome emphasis on need for further supply side improvements by all OECD economies in labour, financial and other markets. And their recognition of the need for continued adjustment policies by the developing countries.

12. The Secretariat rightly argues that cuts in the US Federal deficit could ease interest rate pressures and contribute to the healthy development of the world economy. (If raised). OECD argues such cuts would be deflationary. But existing UK policies are designed to sustain nominal demand and would help insure against any unduly sharp slowdown in activity. If others outside US followed a similar approach prospects considerably better.

EF2

File

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 3133

J C Odling-Smee
Under Secretary

30th May 1985

A Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

EMPLOYMENT EFFECTS OF INCREASES IN INFRASTRUCTURE EXPENDITURE

As promised, I attach copies of the two Treasury notes prepared for the Building and Civil Engineering EDCs, and the latest letter from the Federation of Civil Engineering Contractors (Mr Noar).

Yours,

John

J ODLING-SMEE

file

NOT FOR PUBLICATION

EDC/B(85)21
EDC/CE(85)31

ECONOMIC DEVELOPMENT COMMITTEES FOR BUILDING AND CIVIL ENGINEERING

THE EMPLOYMENT EFFECTS OF PUBLIC EXPENDITURE ON CONSTRUCTION: TREASURY NOTE

Note by the Office

Mr Peter Shaw, H M Treasury, has provided the attached note which describes how the Treasury model is used to produce estimates of the "cost per job" of additional public expenditure on investment.

This note is for discussion at the next meetings of the EDCs.

→ employment - wide benefits
→ main issue overall benefits

Note
Spoke to John Odling-Smee (Treasury) to clarify status of the figures in para 7 and Table A. £47,000 and £51,000 are the first year, direct effects of the two categories of investment. Taking account of indirect effects these figures become £37,000 and £47,000, still in the first year. In subsequent years the crowding out effect gathers strength and the long run effect on jobs is nil.

AT
7/6

2 May 1985
1025/10.2

National Economic Development Office
Millbank Tower
Millbank
London SW1P 4QX

TREASURY MODEL SIMULATIONS OF CHANGES IN PUBLIC EXPENDITURE ON INVESTMENT

This note describes how the Treasury model is used to produce estimates of the "cost per job" of additional public expenditure on investment.

Disaggregation

2. The model identifies three categories of government investment expenditure - central government investment, local authorities housing investment, and local authorities non-housing investment. No further disaggregation within these broad categories is made.

Direct and Indirect Effects

3. It is convenient to distinguish direct from indirect effects. Direct effects of additional public expenditure are those arising as a result of the particular expenditure under consideration, reflecting the response of the relevant suppliers. Indirect effects are those arising from changes in macroeconomic variables - such as interest rates, inflation, the exchange rate, and profitability - which the original expenditure and its direct effects bring about. Direct effects do not necessarily occur before indirect effects, and the former may take some time to build up. The slow build up of direct employment effects is a good example: some of the extra output generated by extra public expenditure may be met initially from greater productivity of the original workforce rather than by higher employment. In practice, the change in employment in the first year will reflect both direct and indirect effects.

Direct Effects

4. The Treasury model calculates these in four stages:

(a) investment is divided into imports and expenditure on domestic output;

(b) the domestic expenditure is allocated between manufacturing and private sector non-manufacturing output;

7. Using the parameters described above, it is possible to calculate the direct cost per person off the unemployment count in the first year. This yields figures of about £47,000 for local authority house building and £51,000 for other Government investment. The calculations are set out in detail in Tables A and B.

difference

TABLE A

Direct Cost per Job for £1 billion additional L.A. Housing Investment

marginal costs

	Equipment	Buildings	Total
Asset Breakdown	0	£1,000m (100%)	£1,000m (100%)
Imports and Domestic Output			
Import Content	-	£200m (20%)	£200m
leaving: Domestic Output	-	£800m (80%)	£800m
of which: Manufacturing	-	£200m (25%)	£200m
Non-manufacturing	-	£600m (75%)	£600m

Employment and Unemployment

	Manufacturing	Non-Manufacturing	Total
Additional Output	£200m	£600m	£800m
Output per Head	£13,000	£12,200	
Employment (Full Effect)	+15,400	+49,200	+64,600
Employment after First Year (= Full effect : 2)			+32,300
Unemployment after First Year (=⅔rds of Employment Effect)			-21,500
Cost per person off unemployment register (£1,000m : change in unemployment)			£47,000

Source: based on co-efficients in the Treasury model

Indirect Effects

9. In order to derive estimates of the total cost per job, it is necessary to allow also for indirect effects. These can be divided into effects tending to reduce the cost per job and those tending to increase it. Among the former are:

(a) multiplier and accelerator effects resulting from the direct increases in output and incomes;

(b) increased tax receipts by the Government;

(c) reduced social security benefits due to the reduction in unemployment.

These factors augment the direct effects on output and employment, and reduce Exchequer costs.

10. Assuming that the money supply remains unchanged, the main factors tending to raise the cost per job are:

(a) higher interest rates, which increase debt interest payments and reduce output and employment;

(b) higher inflation, which reduces real wealth and private expenditure;

(c) worse competitiveness, which causes a deterioration in the net trade balance.

These factors crowd out additional output and employment, and add to Exchequer costs.

11. In the Treasury model, the factors tending to reduce the cost per job outweigh those tending to raise it for the first year. As a result, the overall costs per person off the unemployment count are smaller in the first year than the direct effects. Lags in the response of employment to output mean that direct cost per job is reduced in the second year,

NOT FOR PUBLICATION

EDC/B(85)15
EDC/CE(85)26

ECONOMIC DEVELOPMENT COMMITTEES FOR BUILDING AND CIVIL ENGINEERING

THE EMPLOYMENT EFFECTS OF INFRASTRUCTURE SPENDING

A note by the Treasury

At the meeting of the EDC for Civil Engineering on 9 January, there was some discussion of the different figures for the economic impact of infrastructure expenditure quoted in various contexts. This note discusses some of the different estimates that have been produced and comments on possible reasons for differences between them.

2. Inevitably there will be a range of estimates of the so-called "cost per job" of such spending depending on the assumptions used and the particular model employed. The summary of the report of the work done by the Henley Centre on Forecasting on behalf of the Building Materials Producers which was considered at the January meeting illustrated certain economic effects of investing an additional £1 billion per annum in construction over a five year period. The initial cost was estimated at around £10,000 per permanent job, falling to £5,000 in the second and third years, before rising again to around £10,000 by the end of the programme. The average cost was around £8,000 pa.

3. In a written answer given in the House of Commons on 9 January, the Prime Minister said:

'The cost per job created through infrastructure expenditure can vary substantially according to the nature of the spending. The purpose in quoting the range of figures given in my reply to the right hon Member for Birmingham Sparkbrook (Mr Hattersely) was to indicate that spending on Government investment schemes could be a very expensive way of reducing unemployment.*

The Treasury model simulations suggest that the cost to the PSBR per person taken off the unemployment register might, in the first year, be around £37,000 for local authority housing building; or around £47,000 for central Government investment. Furthermore, the estimated cost per job or per person taken off the unemployment register would rise over time as the increase in employment is eroded by higher interest rates and inflation.'

4. There are three main reasons for the different results produced by Henley and the Treasury using the Treasury model:

a. different assumptions about the import and labour contents of infrastructure expenditure;

b. different assumptions about monetary policy;

c. use of employment rather than unemployment for calculating "cost per job"

5. The Treasury model makes a distinction between housing and non-housing investment, in terms of import and labour intensity, but otherwise is not designed to distinguish between the various categories of public investment expenditure. The Henley centre have increased the model's employment response to allow for the higher labour intensity which they believe

---

*at Hansard, col 1202 on 13 December the Prime Minister suggested a range of between £35,000 and £55,000.

applies to construction spending. However the model of the Warwick Institute of Employment Research suggests that the characteristics of low import content and high labour intensity occur only in some areas of public construction activity. Simulations on this model suggest that the first round costs per job through infrastructure spending range from £16,000 in housing through £32,000 for roads and up to £50,000 for health.

6. Both the Treasury and the Henley estimates quoted above are based on the standard assumption that the extra spending would be financed by higher borrowing. In the Treasury case, interest rates are assumed to be higher that otherwise to keep monetary growth on track. In the Henley case, interest rates are held unchanged. The resulting higher interest rates in the Treasury case offset some of the rise in employment, especially after a little time.

7. A further difference between the Henley and Treasury figures is that the former are based on the increase in employment, not on the reduction in unemployment. The reduction in unemployment is usually assumed to be less than the increase in employment because not all those obtaining jobs as a result of the increased expenditure will have been registered as unemployed.

THE FEDERATION OF CIVIL ENGINEERING CONTRACTORS
COWDRAY HOUSE, 6 PORTUGAL STREET, LONDON WC2A 2HH
TELEPHONE: 01-404 4020. TELEX: 8955101 FCEC G

HM TREASURY – MCU
– 0 MAY 1985

/EXC
21 MAY 1985
Mr Monck
CST, EST, MST, EST
Sir P. Middleton
Mr Bailey

The Rt. Hon. Nigel Lawson MP,
Chancellor of the Exchequer,
H. M. Treasury,
Parliament Street,
London SW1P 3AG

17th May 1985

Mr Battishill
Mr Shaw
Mr Cropper Mr H. Davies
Mr Lord

Dear Chancellor,

You may remember that in reply to a question from the Shadow Chancellor on 13th December last year, the Prime Minister said:

> "Increasing infrastructure is not a cost-effective way in which to increase the number of jobs. The cost per job through increasing infrastrcture can vary from £35,000 to £55,000. It is an expensive method, which tends to lead to a lot of hire of plant but not much hire of men."

Since then I have had an extended correspondence with Michael Alison, the Prime Minister's Parliamentary Private Secretary, to try to discover the source of these, to us, highly surprising figures. This correspondence ended with Mr. Alison suggesting that I should write to you, as the Prime Minister's figures had apparently been produced in the Treasury. I understand that he has in fact been in touch with you about this.

Since then we have received a copy of the note which the Treasury prepared for the Building EDC. In case it may be suggested that this note provides a satisfactory answer to our query, I thought it might be helpful to begin by explaining why we consider that it does not in fact meet the point.

Perhaps the most fundamental objection to the Treasury note, is that it is clearly not addressing itself to the point at issue, which was not as the note states "the cost per job of additional public expenditure on investment," but specifically, in the Prime Minister's words, "the cost per job through increasing infrastructure."

Indeed, from paragraph two of the note it seems clear that the Treasury model does not in fact have a category for infrastructure investment. It, therefore, follows that the Treasury model has not and apparently cannot, support the figure quoted for infrastructure.

/...

The Rt. Hon. Nigel Lawson MP
Chancellor of the Exchequer

It is vital to recognise that infrastructure investment does not merely produce short term jobs. It will produce increasing numbers of new jobs over the full lifetime of the investment. In this respect, at least, it differs from some other kinds of construction, which may be designed to meet social or other important but essentially non-industrial needs.

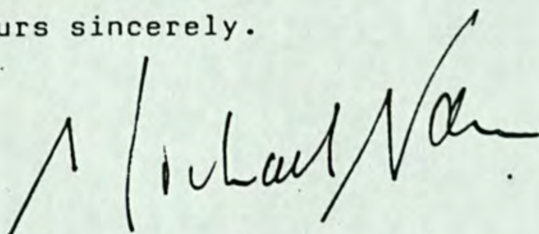
The note, however, makes no mention of this important effect of infrastructure investment. Any examination of the cost of the jobs, which fails to take account of this important long term effect, would clearly produce a hopelessly misleading result.

The note also does not make any attempt to substantiate the Prime Minister's assertion that infrastructure investment leads to more hire of plant than hire of men. We believe that to be factually incorrect. In any event the hire of plant does, of course, itself result in the generation of jobs in the plant hire and manufacturing industries.

For each and all of the above reasons, I cannot accept that the note substantiates the figures quoted by Mrs. Thatcher and in the absence of any further explanation, can only conclude that she was seriously misled on this important aspect of the current debate. However, I would naturally welcome an opportunity to discuss this with the Treasury official who was responsible for these figures, as has been suggested by Mr. Alison.

We do of course challenge the concept that infrastructure jobs cost money at all. Provided that the schemes are, as they should be, profitable in themselves, the jobs should not be regarded as having a net cost but rather as contributing to the profit. However, given that there is understandable interest in the expenditure that would be necessary to generate new employment, it is clearly essential that any figures that are quoted are correct.

Yours sincerely.



Michael Noar,
<u>Director, External Affairs</u>

31 MAY 1985

Prime Minister (2)
A useful counter to Owen, Hattersley and Heath
AT 14/1

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 8850

File

cc F
BI

Andrew Turnbull
10 Downing Street

14 January 1985

Dear Andrew

IFS SIMULATION OF £1 BILLION EXTRA PUBLIC SPENDING

1. We had a brief word this afternoon about wrong use of these results, which were prepared by the LBS for the IFS who published them early last year in their "Green Budget". Mr Hattersley on 6 December (OR cols 535-6) and Dr Owen on 10 January (OA col 901) both reported these as extra public investment in infrastructure. In fact they refer to extra spending on public employment. This is made clear in the attached extract from the IFS document and I understand Mr Odling-Smee has confirmed it with Dr Budd subsequently.

[margin: Mr Heath in his Sunderland Speech]

2. The main thrust of our case against extra government spending as a way of using the fiscal adjustment now no longer rests on quantified model results. Nevertheless I think it would be useful if an opportunity could be found to point to the sloppy homework which Dr Owen, Mr Hattersley and perhaps others have done on this point. It is hardly surprising that spending £1 billion directly on government employment creates lots of jobs!

3. There is a second-order point about the IFS presentation of the comparison between tax cuts and higher spending. Their tax cut package would be about one-third smaller in PSBR terms than their £1 billion public spending package. But there does not seem to be much to be gained by addressing that point at this stage.

4. I attach a copy of briefing which we prepared on this subject for the last Treasury First Order Questions. This may be useful to you.

5. I am sending copies of this letter to Margaret O'Mara, Robert Culpin and John Odling-Smee.

Yours
Mark

M T FOLGER

Appendix E. Macroeconomic Simulations

In Section 4 we presented simulations based on the London Business School Macroeconomic Model of the effects of various changes. This Appendix, written by LBS, describes the main assumptions and mechanisms which lead to the results.

The simulations reported in this Appendix have been carried out on a base run of the new version of the LBS model which has been recently re-estimated to take account of the rebasing of the National Accounts data to 1980 prices. The base run assumes that policy is constant, which is interpreted to mean no changes in tax rates but full indexation of allowances and specific duties. The simulations are all of fiscal changes, and are carried out on the assumption of fully accommodating monetary policy. They are therefore not necessarily compatible with the monetary guidelines or counter-inflationary objectives of the Medium Term Financial Strategy. The assumption that monetary policy is fully accommodating means that fiscal stimulus puts little or no upward pressure on interest rates, and these simulations therefore show a larger increase in demand and hence output than would occur if monetary growth were fixed. The following paragraphs briefly describe the model mechanisms which produce the effects shown in Table E1.

Income tax cut

A classic Keynesian stimulus increases disposable incomes and hence consumption and output. The increase in output has a favourable effect on unit costs and holds down prices at first, but eventually this is outweighed by faster growth of wages reflecting the increased pressure of demand. The stimulus also increases the PSBR which pushes up the money supply and leads to a fall in the exchange rate. This eases the competitive pressure on domestic producers and allows them to increase profit margins. The combined effect of higher wages and a lower exchange rate means that prices are significantly higher by the end of the period, and there is a net deterioration in competitiveness. Imports are boosted substantially both by the extra output and by the rise in domestic prices, and the combined income and price elasticities produce a large deterioration in the balance of payments. The additional output also leads to an increase in employment, but the elasticities are fairly small. The increase in output of 0.9 percent is produced by an increase of 0.6% in the labour force, with the balance coming from improved productivity.

TABLE E1. MACROECONOMIC EFFECT OF SELECTED POLICY CHANGES

		Expected % Changes				
		Income Tax Basic rate to 27%	Allowances 5% more than indexation	VAT to 20%		Pub[illegible]pending + £1 billion
		% difference between base run and variants (except balance of payments and unemployment)				
				a	b	
GDP	year 1	0.4	0.1	- 0.4	- 0.7	0.3
	year 4	0.9	0.2	- 1.8	- 0.8	0.4
Retail prices	year 1	0.1	-	1.0	2.1	0.6
	year 4	1.1	0.3	5.1	-	0.8
Earnings	year 1	0.2	-	0.2	-0.3	0.7
	year 4	1.7	0.4	3.4	- 1.7	1.2
Balance of payments (£bn)	year 1	- 0.5	- 0.1	0.3	1.5	- 0.3
	year 4	- 3.9	- 0.9	2.5	4.0	- 1.5
Real disposable income	year 1	1.6	0.4	- 0.9	- 2.1	0.1
	year 4	2.6	0.6	- 1.7	- 1.7	0.3
Money supply	year 1	0.6	0.2	-	- 0.3	0.2
	year 4	2.3	0.6	- 3.4	- 3.0	0.6
Unemployment ('000s)	year 1	- 30	- 7	- 10	30	- 165
	year 4	- 130	- 30	-	100	- 185

Increase in Allowances

The simulation of changes in allowances is very similar in its effects to the cut in the basic rate. The direction is the same in every case, and the absolute magnitude substantially smaller, reflecting a smaller initial stimulus.

Higher VAT

The effects of changing VAT are notoriously hard to estimate. A great deal depends on the reaction of wages, and it is not clear that the events of 1979, when a large part of the VAT increase was passed on into prices and wages, would be repeated if another VAT increase

were to occur. To illustrate these uncertainties we have shown two sets of results. The first set, in the left hand column, are taken from the version of the LBS model that was being used for forecasting just before the re-estimation on a 1980 price basis. In this simulation the VAT increase is passed on in prices and subsequently affects wages. There is nevertheless a fall in real incomes and output declines. This improves the balance of payments, but the improvement is fairly modest, given the size of the fall in output, because of decline in competitiveness. This comes from two sources: the rise in wages is pushing up domestic costs; and the fall in the PSBR and consequent fall in the exchange rate pushes up the exchange rate. The effect on employment of a decline in output is offset by the fall in *real* wages, and there is no net change in unemployment.

A rather different scenario is shown in the second set of results (in the right hand column), taken from the latest version of the LBS model. The key difference is that wages are assumed to be driven by employers' ability to pay rather than by employees' demands, so the VAT increase is not passed on into wages. As a consequence wages tend to fall rather than rise (compared with the base level) and the improvement in cost competitiveness limits the fall in output and improves the balance of payments. But despite a fall in real wages, unemployment rises in response to the increase in output. The rise in taxes also reduces the PSBR and reduces monetary growth in this simulation, and the consequent effects on the exchange rate and prices offset the original upward impulse from higher taxes.

Taken together these simulations show that under almost any circumstances a VAT increase will reduce real disposable incomes, reduce output and improve the balance of payments. But the long term effect of the VAT increase on prices and employment depends crucially on the reaction of wages, and this is extremely uncertain.

Higher Public Spending

In this simulation an extra £1bn was spent on an increase in public employment. Since the output of public employees is measured in the national accounts by their income this leads to a direct increase in measured GDP, (though it may be questioned whether this accurately reflects the true value added.)

The increase in output has a much larger effect on employment than any other method of stimulating the economy, but as a consequence the effect on prices is also relatively large, as the downward pressure of demand pushes up prices, and the productivity offer is small. The balance of payments is thus affected adversely even though the import content of the extra public spending is relatively small.

Appendix F. The Privatisation of British Telecom

The budgetary position in 1984-5 depends to a considerable extent on the amount raised from the sale of shares in British Telecom. Figures in the range £4bn - £5bn have been widely quoted as the likely proceeds from the sale of a half interest in the privatised concern.

The assets of British Telecom had a historic cost value in 1983 of £8bn net of a stated liability of £1.25bn to the Post Office and British Telecom pension funds. The corresponding current cost figure is £15.3bn. Long term liabilities to lenders other than the UK government were just under £500m (mainly foreign currency lending covered by government exchange guarantees). If the whole of BT's debt to the UK government were transformed into equity, the value of the resulting company would therefore be around £7.5bn (in historic cost terms) and £15bn (in current cost terms).

These figures probably mean little. British Telecom does not have a register of assets owned of the type universally maintained by private companies, and its annual accounts are regularly qualified on this account. More fundamentally, the type of assets with which existing telephone equipment would be replaced today are so completely different that historic cost records, however adjusted, can provide very little indication of the current replacement cost of assets.

The earnings of British Telecom may therefore provide a better guide to its value. In 1981-2 and 1982-3 these were approximately £1.5bn, before tax, interest or supplementary depreciation. BT is unlikely ever to pay Corporation Tax, at this level of profitability, except ACT on its dividends. On a full 52% tax charge, its profits would be £750 million. Applying a price-earnings ratio of 10 (something in between the figures for Cable and Wireless and the old style AT and T, for the two most comparable stocks) would suggest a value of £7.5bn. This is evidently a low figure — a more realistic tax charge would imply a much higher value, a conservative policy would indicate a higher earnings multiple.

However this takes no account of any prospect of increased efficiency in British Telecom, which is suggested as an argument for privatisation. A 5% reduction in operating costs would increase profits by about £250 million per annum. Nor does it take account of the opportunity for a privately owned BT, which is unlikely to be subject to a significant competition in the major part of its business, to raise prices. Suppose a 25% increase in tariffs across the board led

LBS results suggest extra public spending on infrastructure produces more jobs than tax cuts?

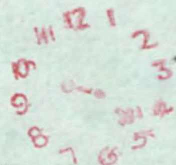
[Mr Hattersley wrongly said (OR cols 535-6 6 December) that LBS simulations, conducted in conjunction with IFS in early 1984, referred to extra £1 billion spent on public "infrastructure". In fact they referred to extra spending on government employment. Results suggested that after 4 years, £1bn addition to PSBR used for this purpose would mean 185,00 new jobs, compared with 30,000 flowing from raising personal allowances at PSBR cost of perhaps £0.6 billion. Note that simulations did not assume fixed monetary framework - IFS describe them as "not necessarily compatible with the monetary guidelines or counter - inflationary objectives of the MTFS".]

RHG should do his research more carefully. LBS figures with which he misled the House are estimated results of spending more on government employment, not infrastructure. Any government can give a short run boost to jobs if it simply takes on huge numbers of extra civil servants. But this soon chokes wealth - creating sectors of the economy and makes problems worse. LBS results show prices higher, and balance of payments worse, if PSBR raised to cover extra government spending.

LBS figures assume higher spending would be covered by a £1 billion increase in the PSBR, Within the MTFS framework net number of jobs arising from extra £1 billion spent on government employment would be much less than 185,000.

[IF PRESSED] IFS presentation of LBS results misleading as their tax cut package would be about one third smaller in PSBR terms than their £1 billion public spending package.

14 JAN 1985



Mr. Moore: My attention was drawn to that broadcast. The Opposition clearly have an innate desire to stay firmly in Opposition and have no interest in Government.

Books and Periodicals (VAT)

17. **Mr. Lofthouse** asked the Chancellor of the Exchequer if he will make a statement on his consideration of the possible imposition of value added tax on books, magazines and newspapers.

Mr. Hayhoe: I refer the hon. Member to the answer I gave earlier to the hon. Member for Walsall, North (Mr. Winnick).

Mr. Lofthouse: Is the hon. Gentleman aware that the price of many of the major newspapers is already beyond many millions of people? Is he also aware that if VAT is introduced, as has been suggested, many local newspapers will be put out of business and many local communities denied the knowledge that they provide?

Mr. Hayhoe: I have met a deputation from the Newspaper Society, which made many of those points in greater detail. The Government are well aware of the representations that are being made, and those representations will be given careful consideration.

Publishers' Association

19. **Mr. Adley** asked the Chancellor of the Exchequer if he has yet met the Publishers' Association or its representatives to discuss his forthcoming Budget; and what was discussed.

Mr. Hayhoe: No, Sir.

Mr. Adley: May I assume that my right hon. Friend, with his usual courtesy, would be willing to meet them if requested?

Mr. Hayhoe: I think that the arrangements have been made and a date has been fixed.

PRIME MINISTER

Engagements

Q1. **Mr. Terry Lewis** asked the Prime Minister if she will list her official engagements for Thursday 13 December.

The Prime Minister (Mrs. Margaret Thatcher): This morning I presided at a meeting of the Cabinet and had meetings with ministerial colleagues and others. In addition to my duties in the House, I shall be having further meetings later today.

Mr. Lewis: What forecasts has the right hon. Lady made of a reduction in unemployment, and when is such a reduction likely to take place?

The Prime Minister: I follow the example of successive Ministers and Prime Ministers in not making forecasts about the rate of unemployment.

Sir Anthony Kershaw: Has my right hon. Friend noticed that an order for the biggest oil rig ever to be built has been obtained on Clydebank? Is it not true that that has happened because the firm concerned has had a 12-year strike-free record? Is my right hon. Friend aware that, as a result, the firm will now be able to take on 500 men?

The Prime Minister: I have noted that the oil rig order has gone to that shipyard. I congratulate the yard on its record and on winning the order. I hope that others will take the hint that strikes destroy jobs and that a good working record wins new orders.

Mr. Hattersley: First, may I welcome the Parliamentary Secretary to the Treasury back to his place on the Treasury Bench? The right hon. Gentleman represents — indeed, personifies — the triumph of democracy over terrorism. [HON. MEMBERS: "Hear, hear."]

Secondly, may I ask the Prime Minister whether she has read the three surveys published today, including one based on the Treasury's own model and one from the London business school, previously the fount of all economic wisdom? Those surveys prove that increases in public investment are by far the most effective way of reducing unemployment. Will the right hon. Lady now respond to the demands from both sides of the House and accept that whatever additions can be made to public expenditure in the spring will not be used for cutting taxation but for reducing the wholly unacceptable level of unemployment?

The Prime Minister: No, I do not accept some of the findings of those three reports or the right hon. Gentleman's specific description of them. Other findings point to other conclusions. As the right hon. Gentleman will know, we realise by now that one cannot spend one's way out of recession. That has been tried before. It leads to higher inflation and ultimately to higher unemployment. There are some 12 million taxpayers with an income of £8,000 a year or less. They, too, have a right to look to the Government to raise thresholds so that they pay less tax. They will never get equity from Labour; they will get it only from us.

Mr. Hattersley: It should be obvious even to the Prime Minister that money invested directly in the United Kingdom is more likely to create jobs than money devoted to increasing consumption, which, by its nature, is likely to result in higher imports and to create jobs abroad. On the Labour side of the House and, I believe, widely throughout the country, it is understood that the right hon. Lady's obsession with a cut in direct taxes is matched and mirrored by the increased indirect taxation that has more than compensated for the reduction in that particular over the past five years.

Most important of all, as the Prime Minister has chosen the high unemployment option, are we to be relieved from now on of the lowered voice and the bogus compassion? The truth is that the Prime Minister and the Government choose high unemployment. That is the message that should be given to the country.

The Prime Minister: The right hon. Gentleman is not correct. Increasing infrastructure is not a cost-effective way in which to increase the number of jobs. The cost per job through increasing infrastructure can vary from £35,000 to £55,000. It is an expensive method, which tends to lead to a lot of hire of plant but not much hire of men. Reduction of tax can lead to extra jobs, as it leads to extra demand. The right hon. Gentleman's thesis that investment always leads to purchases from home sources while reduction of tax leads to purchases abroad is not correct. In an age of specialisation much of the investment in equipment and machinery goes abroad.

FROM: MR GLEED

DATE: 9 JANUARY 1985

cc:	Chancellor of Exchequer	Mr Monck
	PS/Chief Secretary	Mr Battishill
	PS/Financial Secretary	Mr Evans
	PS/Economic Secretary	Mr Odling-Smee
	PS/Minister of State	Mr Culpin
	Sir Peter Middleton	Mr Mowl
	Sir Terence Burns	Mr Folger
	Mr Bailey	Mr Riley
	Mr Byatt	Mr Cropper
		Mr Lord

PARLIAMENTARY SECTION

HATTERSLEY SPEECH: IMPORT CONTENT OF TAX CUTS

You asked for a note for No 10.

Mr Hattersley's speech referred to "summary tables, published by the Department of Trade and Industry", which put the import content of consumers' expenditure at 20% and of investment at 30%. He went on, however, to say that the construction industry attracted only 15% import content, while electrical consumer goods and man-made fibres, which would attract a large part of increased consumer spending, had import contents of 42% and 39% respectively. So tax cuts were much more likely to stimulate jobs abroad at the expense of British industry than were increases in public capital programmes.

The tables Hattersley referred to are the 1979 Input-Output Tables, published by HMSO. They detail (inter alia) the <u>average</u> import content of different kinds of expenditure and different sectors of the economy in 1979. They are used widely both in the Treasury and elsewhere, for analysing the structure of the economy. Table 1 below summarises their findings on average import contents.

<u>Marginal</u> import contents, ie the proportion of <u>additional</u> expenditure which would leak into imports, are more difficult to establish. For public sector investments, they depend very much on the details of the projects. Nonetheless we think that marginal import propensities are considerably higher than the average propensities.

This [illegible]
tax cuts may generate fewer jobs than some of the more employment-intensive public investment programmes (eg housebuilding). But the main arguments for tax cuts are their longer-term effects [illegible] incentives via reductions on the poverty and unemployment trap and their stimulation of enterprise, rather than their short-run effects on employment. The plain fact is that low tax economies work better than high tax economies. Look at the US and Japan.

The best response to Mr Hattersley on the question of import propensities would be to explain that in anything but the short run, tax cuts will lead to more jobs than would extra capital spending. The question of imports is not of over-riding importance in itself. The figures Mr Hattersley quotes themselves show that the average import content of some kinds of investment can be higher than that of consumer spending. This is all the Prime Minister was seeking to establish in her remarks before Christmas.

Richard Gleed

MR GLEED

Table 1

Average Import Content[1], 1979

(percent of total final expenditure for each category or sector)

	%
A. Expenditure Categories	
Consumers' expenditure	21.2
General Government final consumption	11.0
Gross domestic fixed capital formation	29.9
Stockbuilding	38.6
Exports	25.6
Total final output	22.0
B. Some Sectors	
Manufacturing	25.6
Construction	14.2
Services other than transport, communications, distribution and business and financial services	2.7
Total final output	22.0

[1] These figures measure the import content, both direct and indirect (ie as a result of purchases from other sectors), of each expenditure category (A) or of the gross output of some sectors (B). They are derived from the Input-Output Tables for 1979, since when average import contents have probably risen.

INVESTMENT VS TAX CUTS

General Line to Take:

In the short term, both tax cuts and greater public investment can create employment. In the long term, however, increased public expenditure means higher taxation, higher borrowing, higher interest rates - and fewer jobs. If public spending could create jobs, the last Labour Government would have slashed unemployment; instead, if doubled under them.

PSBR Cost Per Job of Public Investment

Approximately £47,000 per job for Central Govt. investment
Approximately £37,000 per job for local authority house-building
Approximately £35,000 per job for regional assistance

Effects of Tax Cuts

In the long term, tax cuts stimulate enterprise and improve incentives, by reducing the unemployment and poverty traps. As the Rt. Hon. Member for Leeds East recognised in his 1978 Budget, tax cuts also help to restrain industrial costs and improve competitiveness. He said (Official Report, 11 April, 1978, Col. 1208):

> "With the rate of inflation remaining low, and with these substantial tax reliefs, modest increases in earnings should ensure that real living standards can continue to rise over the year ahead without unduly increasing our industrial costs. This is the best possible recipe for commercial and industrial success. It is the only recipe for curing unemployment."

That was true then and it is true today.

Government Record

Under this Government:

- public sector investment remains at about the same real level as in 1978/9 (£24 billion); Government repairs and maintenance contracts are worth £5 billion more;

- total fixed investment across the economy as a whole was running at an all time record in 1984 (£55 billion);

- manufacturing investment rose by about 15% in the first three quarters of 1984 compared with a year earlier; investment in construction and service industries by $12^1/4$ % over the same period.

In particular sectors:

- investment in the water industry is expected to be £850 million next year - 9% up on this year;

- investment in major roads this year will be 27% greater in real terms than in 1978/9. £350 million has been spent on the M25 alone.

International Experience

If public expenditure could save unemployment, Europe would not have a problem. Countries which have been most successful in creating new jobs have public expenditure and taxation which is 10% lower as a proportion of GDP than in this country.

<OECD figures for 1982:

	Public expenditure as a proportion of GDP	Taxes and Contributions as a proportion of GDP
USA	37.6%	30.5%
Japan	34.5%	27.2%
UK	47.4%	39.6% >

Import Content of Tax Cuts/Investment

The point I was making was that contrary to what the Rt. Hon. Gentleman said in the House on 13 December, the average import content of some kinds of investment can be higher than that of consumer expenditure. If the Rt. Hon. Gentleman believes that increased demand only leads to increased imports, why did he call for a massive expansion of demand at the last Election?

<Figures: 1979 Input-Output Tables published by HMSO:

Average input content of:

Consumers expenditure	21%
Construction	14%
Gross domestic fixed capital Formation	30%

>

E.R.

AT

PRIME MINISTER

EMPLOYMENT EFFECTS OF EXPENDITURE INCREASES

In the note prepared for the Chancellor by Treasury officials, there were estimates of the employment effects of an extra £1 billion of public investment. (Note is attached). The Chancellor is still considering how best to present this material. His difficulty is that the effect on employment of £1 billion of income tax cuts is even smaller in year one, perhaps only 5,000. Put another way the cost per job created by tax cuts is probably around £150,000, compared with £47,000 for central government investment. Over time, the effect of investment is likely to fall away while the supply side benefits of income tax cuts are likely to build up over time. The Treasury model is weak in capturing these effects but officials estimate it might be year four before the two paths cross. There are dangers, therefore, in using the model to show a detailed path for investment expenditure as this could provoke requests for the path for tax cuts to be shown, which are not well captured by the model. The Chancellor thinks that until the presentation of tax cuts has been more fully developed, no figures on the time path of the two policy options should be released.

The best way to present the argument is probably in stages:-

(i) Extra infrastructure expenditure is likely, even in the short run, to be an expensive way of creating new jobs - the precise effects will vary with the nature of the investment - and one which is less and less effective over time as the impact of higher interest rates is felt.

(ii) The Government rejects the view that higher expenditure financed by higher borrowing will help. Therefore there has to be a choice between higher public expenditure and tax cuts. Some

models suggest initial impact on jobs is greater than with personal tax cuts. But Government needs to look at longer term impact. With tax cuts, the number of jobs is likely to build up over time as economy's supply performance improves. So for given initial impact on PSBR, tax cuts likely to produce more jobs in the long run. It is the cumulative result of the short term decisions of successive Governments that has produced the unemployment and poverty traps.

(iii) Those economies which have held down expenditure and taxes, and where real wages have grown more slowly have been most successful in creating employment.

Tim is putting this argument into speaking note form for Questions.

9 January 1985

CC Prem Office

97/2

From: J ODLING-SMEE
20th December 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Bailey
Mr Byatt
Mr Monck
Mr Battishill
Mr Folger
Mr Riley
Mr G Smith
Mr G White
Mr Gleed
Mr Ritchie
Mr Cropper
Mr Lord
Mr Ridley

EMPLOYMENT EFFECTS OF TAX CUTS AND EXPENDITURE INCREASES

We are preparing two or three notes on this subject. The main material will reach you tomorrow. But I thought that you might like to have in advance the attached briefing note which you requested following the Prime Minister's statements last week. It is designed to use in public, and may therefore be more urgent than the internal papers that I shall be submitting tomorrow.

2. The note quotes some numbers from simulations of the Treasury model The first year cost per job estimates are consistent with the Prime Minister's statement that the cost per job of expenditure on public infrastructure was in the range of £35,000-£55,000. However, the estimated cost per job rises over time as the initial increase in employment is crowded out. The version of the model on which these simulations were carried out is public, and so others could in principle reproduce these results.

3. We believe that these numbers are consistent with others which have been quoted recently. Although the cost per job is higher than that implicit in Huhne's article in the Guardian of 13th December, the difference can probably be explained mainly by different monetary policy assumptions: we assume fixed money supply, whereas he assumes fixed

interest rates. Our numbers are also consistent with those in the recent piece from the Warwick University Institute for Employment Research (which we shall be commenting on in tomorrow's note), when allowances are made for the increase in prices since 1982 and for the difference between unemployment and employment.

4. The note does not provide any figures for the import content of different types of expenditure. For the reasons given by Mr Folger in his minute of 14th December, it would be best to avoid being drawn into a discussion on this subject. I understood that this was also your view.

John O-S

J ODLING-SMEE

PUBLIC SECTOR INVESTMENT AND EMPLOYMENT

Note by the Treasury

This note presents estimates of the short-term impact of additional public sector investment on employment. These suggest that, given the Government's medium-term financial strategy, any initial increase in employment will be short-lived.

2. The impact of additional public sector investment on employment in the short term depends on a number of factors, especially:

- the labour-intensity of the project: housebuilding, for example, involves more jobs than motorway construction;
- the import-intensity of the project: when major pieces of machinery (eg aircraft, earth-moving equipment) have to be imported fewer jobs are created in the UK;
- the adverse effects on employment elsewhere of some of the wider economic consequences of higher public expenditure, especially higher interest rates and inflation.

3. Any single estimate of the short-term employment effects of additional public expenditure must be conditional on the assumptions that are made about these factors. Unless specific projects are under review, it is necessary to assume that they have the characteristics of the "average" project.

4. Simulations on the Treasury model of a permanent increase in annual investment of £1 billion produce the following estimates of the change in unemployment in the short term:

Change after	Central Government Investment	Local Authority housebuilding
One year	-20,000	-20,000
Two years	-20,000	-30,000
Three years	-10,000	-10,000
Four years	0	10,000

NOTE: The Treasury model discriminates between housing and non-housing investment in terms of their import-intensity and labour-intensity, but it does not distinguish between categories within non-housing investment.

5. It is assumed in these simulations that, consistently with the Government's medium-term financial strategy, interest rates rise in order to keep money supply growing at an unchanged rate despite the higher borrowing. Largely because of the higher interest rates and a temporary rise in inflation, the reduction in unemployment is not sustained beyond the third year in the simulations.

6. The initial "cost per job" in the sense of the rise in the PSBR in the first year for each person taken off the unemployment register by the end of the first year is £47,000 for central government investment and £37,000 for local authority housebuilding. These figures are many times higher than the costs per job of specially-targetted employment and training measures.

7. They are lower than the initial "cost per job" estimates of a reduction in income tax derived from the Treasury model. However, the true "costs per job" will be lower than the model estimates, because the model does not include an allowance for the incentive effects of income tax cuts on enterprise and effort. These supply-side effects are likely to build up over time, and hence the "costs per job" will fall. By contrast, the "cost per job" estimates of additional public investment tend to rise over time as the gain in unemployment is eroded.

-8 JAN 198[illegible]
-8 JAN 198[illegible]

[illegible]

	PSBR £m	Employment (000's)	Unemployment (000's)	GDP (%)	Inflation (% pts)	Earnings Growth (% pts)	Short term Interest Rates (% pts.)
Investment in New Buildings and Works +£1b (financed by borrowing)							
Year 1	-200	40	-20	0.35	0.1	0.2	0.4
2	-200	40	-30	0.25	0.2	0.2	0.5
3	-100	20	-10	0.05	0.15	0.15	0.5
4	200	0	0	-0.05	0.0	0.0	0.5
Investment in New Buildings and Works +£1b (financed from company sector liquidity)							
Year 1	-200	40	-30	0.4	0.1	0.2	0.2
2	-400	60	-40	0.35	0.2	0.3	0.25
3	-400	40	-30	0.25	0.25	0.3	0.15
4	-200	0	0	-0.75	0.15	-0.05	-0.15

	PSBR £m	Employment (000's)	Unemployment (000's)	GDP (%)	Inflation (% pts)	Earnings Growth (% pts)	Short-term Interest Rates (% pts)
Current Expenditure + £1bn 50% Employment, 50% Procurement							
Year 1	800	70	-40	0.25	0.1	0.25	0.45
2	900	60	-40	0.2	0.2	0.25	0.6
3	1100	40	-30	0.15	0.15	0.2	0.65
4	1400	20	-10	0.05	0.05	0.05	0.75
Current Expenditure + £1bn - All Employment							
Year 1	600	100	-70	0.3	0.1	0.3	0.45
2	900	100	-60	0.2	0.2	0.3	0.65
3	1200	70	-50	0.05	0.15	0.2	0.7
4	1500	50	-30	-0.0	0.05	0.1	0.8
Current Expenditure + £1bn - All Procurement							
Year 1	900	30	-20	0.25	0.1	0.2	0.4
2	900	30	-20	0.15	0.2	0.2	0.6
3	1100	10	-10	0.05	0.15	0.15	0.6
4	1300	-10	10	-0.05	0.05	0.05	0.65
C.G Investment + £1bn							
Year 1	1000	30	-20	0.3	0.1	0.2	0.4
2	1000	30	-20	0.2	0.2	0.2	0.6
3	1100	10	-10	0.1	0.15	0.2	0.6
4	1400	-10	0	0.0	0.05	0.05	0.7
-A. Investment + £1bn							
Year 1	900	40	-20	0.35	0.1	0.2	0.45
2	900	40	-30	0.2	0.2	0.2	0.65
3	1100	10	-10	0.05	0.2	0.25	0.7
4	1400	-20	10	-0.1	0.05	0.1	0.75

19:1

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cc TF/ Press Office Copies

Sheenagh Wallace

AT

FROM: M T FOLGER
DATE: 14 December 1984

CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Byatt
Mr Monck
Mr Battishill
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr G White
Mr McDonald
Mr Stredder
Mr M Williams
Mr Vernon
Mr Cropper
Mr Lord
CA/01

Note

I briefed Press Office to say that the import figures in para 7 were not part of a sophisticated argument comparing differing policy options, but a quick way of illustrating point that investment was not necessarily lower on imports than tax cuts. This is particularly so for industrial plant and machinery.

AT
17/12

PUBLIC SECTOR INVESTMENT: COST PER JOB, IMPORT CONTENT

This note seeks your approval for the briefing line to be taken on these issues in the light of remarks by the Prime Minister on 13 December.

Cost per job

2. At OA col 1202 the Prime Minister said inter alia "the cost per job through increasing infrastructure can vary from £35,000 to £55,000." (Full Hansard entract attached at A.)

3. No figures have been given recently for the "cost per job" of such spending. It is possible that the Prime Minister may have been misremembering figures from the "Monck Report" (submitted under Mr Monck's 3 August minute to you). Table 2 of that report (copy attached at B) gave (classified) figures for the first year PSBR costs per job of central government investment as £35 to 45 thousand (and £25 to 35 thousand for local authority investment). £35 to 55 thousand is thus distinctly at the top end of the range.

4. I have agreed with Mr Monck, MP and EI divisions a form of words for use should the Prime Minister or others need to refer to this point again. It is designed to stress the relativity with SEMs, whilst at the same time clawing the cost per job figures back into the right ballpark, yet without contradicting what was said yesterday. The proposed wording is:

"Government investment not cost-effective way to create jobs

[PM OA col 1202 13 December 1984]

Spending on government investment schemes would be a very expensive way to create jobs. Typically the cost per job might be more than ten times that of

specially-targetted employment and training measures. [IF PRESSED: For public investment schemes, the cost to the PSBR might be between £25,000 and £35,000 in the first year, and could range even higher, for each person taken off the unemployment register.]"

5. If you are content with this line then it would be helpful if your office could inform No.10 accordingly on Monday morning. The words can then be taken into briefing for Questions next week.

<u>Import content of different types of expenditure</u>

6. You may have noticed that the Prime Minister is reported to have given figures for this at the 1922 Committee on the evening of 13 December (see FT story attached at C).

7. She was drawing on figures, provided at No.10's request by MP, as follows:

<u>average</u> import content, per cent

consumers' expenditure	21
construction	14
GDFCF(domestic capital formation)	30

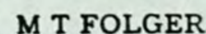
The Prime Minister's use of these figures may have served to redress the balance of argument about the choice between public investment and income tax cuts.

8. Nevertheless we have advised No.10 for the time being that, although the figures have now leaked onto the record from a supposedly private Party meeting, they should not be put into general circulation in standard briefing material. This is because:

(a) the figures are <u>average</u> propensities (although reported as marginal by the FT). The marginal propenities suggested by the Treasury Model might be roughly double these average estimates.

(b) in that Mr Hattersley and others are not pressing for extra spending on "average GDFCF", but for "infrastructure" and "housing" spending, then the relevant propensity could plausibly be argued to be more like 14 per cent than 30. On that basis, and on Mr Hattersley's view of the world, it would be preferable to consumption with its average propensity of 21 per cent. So the average relativities are not very helpful to the government's case.

9. No.10 are aware of these problems and your office will confirm our interim advice to them on Monday unless you would like us to take a different line.



M T FOLGER

A

OA col 1202 14 December 1984

Mr. Hattersley: It should be obvious even to the Prime Minister that money invested directly in the United Kingdom is more likely to create jobs than money devoted to increasing consumption, which, by its nature, is likely to result in higher imports and to create jobs abroad. On the Labour side of the House and, I believe, widely throughout the country, it is understood that the right hon. Lady's obsession with a cut in direct taxes is matched and mirrored by the increased indirect taxation that has more than compensated for the reduction in that particular over the past five years.

Most important of all, as the Prime Minister has chosen the high unemployment option, are we to be relieved from now on of the lowered voice and the bogus compassion? The truth is that the Prime Minister and the Government choose high unemployment. That is the message that should be given to the country.

The Prime Minister: The right hon. Gentleman is not correct. Increasing infrastructure is not a cost-effective way in which to increase the number of jobs. The cost per job through increasing infrastructure can vary from £35,000 to £55,000. It is an expensive method, which tends to lead to a lot of hire of plant but not much hire of men. Reduction of tax can lead to extra jobs, as it leads to extra demand. The right hon. Gentleman's thesis that investment always leads to purchases from home sources while reduction of tax leads to purchases abroad is not correct. In an age of specialisation much of the investment in equipment and machinery goes abroad.

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B

Table 2: First year PSBR costs of broad public expenditure categories**

(£thousand)

	Per person off the unemployment count	per net person employed
Central Government employment	8-10	5-7
Central Government current expenditure on goods and services (including direct employment)	15-20	10-15
Local Authority investment	25-35	15-25
Central Government investment	35-45	20-30

** All figures relate employment/unemployment effects in the fourth quarter of the year to PSBR effects for the year as a whole. They are based on the assumption that monetary growth is unaffected; that interest rates adjust to ensure this; and that the expenditure constitutes a net addition to total public expenditure, and hence an increase in the PSBR.

FT 14 December 1984

Attempt to ease pension fears

BY PETER RIDDELL, POLITICAL EDITOR

ANY ACTION in the Budget to tax lump pension payments will not be retrospective and no-one will gain from retiring before Budget day rather than after, Mr Nigel Lawson, the Chancellor told MPs yesterday.

His remarks in Commons Treasury Questions were intended to end the wave of threatened, and actual, early retirements, particularly among police officers and others in the public and private sector, who fear the possible introduction of such a tax.

Senior Tory MPs, the pensions industry, and yesterday, the Confederation of British Industry, have pressed Mr Lawson for an early statement to end the uncertainty. But his Commons comments offered only partial re-assurance.

He refused, in accordance with normal practice, to confirm or deny speculation about his Budget plans but said he was "concerned at reports that some people may be contemplating premature retirement on the basis of rumours on the tax treatment of pension lump sums.

"I can assure the House that there is no reason for anyone to retire early on account of such rumours. This Government would not propose, and the House would not accept, retrospective legislation of that kind."

He made plain that his remarks were intended solely to deal with fears leading to such premature retirement.

The implication is that if such a tax were imposed—which is far from certain—amounts which have accrued to finance a lump sum payment before Budget Day would not be affected. Any changes would affect only the part of a person's career after then.

Mr Lawson refused, however, to be drawn on questions about whether any changes would apply to people who became members of pension schemes before Budget Day. Similarly, he sidestepped questions about whether contributions to occupational pension schemes might be taxed.

As a result, some Tory MPs afterwards felt his answers did not go far enough. Dr Oonagh McDonald, one of Labour's Treasury team, said Mr Lawson's remarks would only create more uncertainty among employees and employers by failing to say whether a tax might be imposed on contributions to pension schemes and/or on their investment incomes.

Continued from Page 1

Scope for tax cuts

He would then be able to moderate the effect on special interest groups by using the £13½bn scope for tax cuts which the Treasury plans to deliver in the four years between 1985-86 and 1988-89.

Significantly, Mr Lawson told the Treasury and Civil Service Committee recently that he is still looking towards a four-year tax-cutting programme of this size.

Ministers have made it clear that the main tax-cutting emphasis next year will be on raising income tax thresholds and allowances. The aim is to improve incentives for all workers and to reduce the number of people in the tax net.

An increase in thresholds would also be intended to improve incentives for the unemployed to take lower-paid jobs.

A cut in national insurance contributions next year seems unlikely, in spite of the fact that it could ease unemployment by directly reducing the cost of labour. Company liquidity is greatly improved this year and the Confederation of British Industry has not been pressing strongly for a cut in employers' contributions.

Replying to recent backbench calls for additional public capital investment, Mrs Thatcher last night gave Treasury figures showing that 21 per cent of additional consumer spending went on imports but that the proportion of extra capital investment spent on purchases overseas was 30 per cent.

Mrs Thatcher used statistics to argue that the Government's 18-month record after the last election was much better than at the same stage of the last parliament.

She said that the most important thing on people's minds was unemployment, but that if the Government had "cut and run" to a spending philosophy it would never have won the last election.

17 DEC 1984

File

FROM: COLIN MOWL
DATE: 22 MAY 1985

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr A M Bailey
Mr Littler
Mr Byatt
Mr F Cassell
Mr Monck
Mr Kemp
Mr Battishill
Mr Evans
Mr Lankester
Mr Odling-Smee o/r
Mr Scholar
Mr Sedgwick o/r
Mr Lavelle
Mr Culpin
Mr Folger
Mr S Davies
Miss Peirson
Mr Riley
Mr Gilhooly
Mr Page
Mr H Davies
Mr Cropper
Mr Lord
Mr Turnbull - No 10

NATIONAL INSTITUTE ECONOMIC REVIEW

The May National Institute Economic Review will be published at 9 p.m. tonight. As well as the usual economic forecasts there are four special articles, on public services pay, real wages and employment, household savings, and schooling standards in England and Germany. A separate note by Mr Gilhooly on public services pay is attached. MP1 will be submitting later briefing on the real wages and employment article.

The Forecast

2. The Institute are slightly more optimistic about output and significantly more optimistic on inflation than they were in February. The better outlook for inflation mainly reflects the recent appreciation of sterling. The table attached compares the NIESR and FSBR forecasts.

3. Despite the upward revision the Institute's forecast of output is at the pessimistic end of the spectrum. While GDP in 1985 as a whole is forecast to be 3¼ per cent higher than in 1984 (1 per cent as a result of the recovery from the coal strike), only 1¼ per cent whole year on whole year growth is forecast for 1986. Indeed the economy is expected to be virtually stagnant in 1986, with hardly any rise in output during the course of the year.

4. In 1985 the most buoyant components of demand are exports and stocks. Exports of goods and services are forecast to rise by nearly 9 per cent in volume terms. This is a rather larger increase than in the FSBR forecast but we would not take issue with it given the recent good performance of exports. The Institute forecast of stockbuilding - an increase in stocks in 1985 of nearly £2 billion in constant prices compared with a rundown of £½ billion last year - is more difficult to believe. Some turnround in stocks, as in the FSBR forecast, is to be expected as a result of the end of the coal strike but the Institute appear to have overdone it, especially as they forecast little fall in interest rates. No other forecasting group has figures anywhere near as high, and figures published tomorrow for industry's stocks in 1985 Q1 show a noticeable fall.

5. The stagnation in 1986 is the result of virtually no rise in fixed investment and government consumption, a much lower rate of stockbuilding and only a small rise in exports. The depressed picture for investment is partly due to falling private housing and public investment, but the Institute also think that the boom in manufacturing investment may be waning. The bringing forward of investment associated with the phasing out of capital allowances is one factor mentioned. The slowdown in exports is attributed to the recent appreciation of sterling and a slowdown in world trade. The Institute's forecast of consumers' expenditure, increases averaging 2 per cent a year, may be on the low side as it implies the maintenance of a high saving ratio, though they justify it partly by reference to high interest rates.

6. On the basis of the prospect for output just described the Institute envisage that unemployment will continue to edge gradually upwards, with the seasonally adjusted figure excluding school leavers reaching 3¼ million by end of 1986.

7. The Institute are forecasting modest current account surpluses of £1-1½ billion for both 1985 and 1986, somewhat lower than in the FSBR forecast, but in line with the average of outside forecasts. Little improvement is envisaged in 1986 despite the projected slowdown in growth partly because some of the slowdown is due to less buoyant exports and partly because the oil surplus is expected to fall as a result of an appreciation of sterling against the dollar. As usual the Institute devote virtually no space to a discussion of the prospects for invisibles, although as it happens their overall forecast for 1985 is similar to ours. They see little rise in the invisible surplus in 1986 however, and appear unduly pessimistic on IPD in both 1985 and 1986.

8. The Institute assume that 3 month interest rates will fall to 11 per cent towards the end of this year from current levels of 12½ but that there will be no falls thereafter. The 11 per cent figure is not actually given in the Review and comment there is in terms of rates 'easing a little further in the near future, but remaining unchanged thereafter'. Against this background sterling is expected to retain much of its recent strength, averaging 76 in 1985 and 75 in 1986. But general dollar weakness is forecast to lead to an average sterling/dollar rate of 1.27 this year and 1.40 next year.

9. MO is forecast to be just below the upper end of its target ranges both in 1985-86 and 1986-87. £M3, on the other hand, is expected to overshoot its target substantially in both years, partly as a result of strong private sector demand for credit. But the PSBR is also expected to overshoot the FSBR projections by large amounts, by £1¼ billion in 1985-86 and, adjusting for different assumptions about the fiscal adjustment, by over £6¼ billion in 1986-87.

10. Large discrepancies between NIESR and official PSBR projections have been a feature for some time and it has been difficult to explain them. Generally, however, we have concluded that key aspects of the NIESR forecast have been misconceived. This view receives some support from the fact that NIESR's forecast for 1985-86 is now much closer to ours than it was in February. As NIESR say themselves the current difference for 1985-86 is probably not significant given the margins of error. This is not the case

for 1986-87, though part of the difference can be explained by NIESR's more depressed economy. NIESR's projection of oil revenues is £2 billion lower than the MTFS, but our rough calculations suggest that given their assumptions on production and sterling oil prices their revenue forecast is too low, possibly by well over £2 billion.

11. Ironically, at a time when recent RPI figures have been turning out higher than expected, NIESR's forecast for inflation at the end of 1985, at 5¼ per cent, has been revised down and is now much closer to the official projection of 5 per cent. NIESR have a further slight deceleration to 5 per cent at the end of 1986, compared with the official forecast of 4½ per cent at mid-1986. As explained earlier NIESR's downward revision is mainly due to a higher exchange rate.

Line to take on the Forecasts

12. **Points to make:**

(i) NIESR show continued economic growth this year, only a little below the Government's forecast.

(ii) NIESR inflation forecast has been revised down and is now much closer to the Government's.

Defensive Points

(i) Economic stagnation in 1986 and a further rise in unemployment?

Prospects for 1986 highly uncertain at this stage. NIESR are more pessimistic on output than most independent forecasters and the Government Forecast.

(ii) NIESR calculate that exports to the USA have not risen over past year in volume terms despite buoyant US economy?

NIESR calculations as they themselves admit are crude.

Moreover NIESR Figures are for total exports but US oil imports have been depressed. UK exports of goods other than oil to US

probably have risen in volume terms, and probably at much same rate as non-oil exports to the EC.

Policy

13. In a short section on the Budget, NIESR observe that one of the main results of the NIC changes will be to increase part-time employment, but it goes on to claim that the effect on registered unemployment is "qualitatively unclear" - essentially because the additional (low-paid and/or part-time) jobs may be for the most part filled by people previously not on the register. This is an unnecessarily agnostic statement; for unemployment to rise, it would require that almost all of the additional low-paid jobs were filled by people not on the register, whilst any loss in better-paid jobs was matched by a corresponding rise in registered unemployment. This would be an extreme and unlikely outcome.

14. The policy appraisal section on this occasion makes only a brief reference to the Institute's well known advocacy of fiscal expansion which, it claims, "now seems to be widely supported".

15. The appraisal goes on to say that demand expansion should be complemented by supply side measures, especially investment in human capital. It bemoans the falling number of apprentices in manufacturing and calls for greater numerical skills to be taught in schools. But most of the appraisal is devoted to a general call for government and industry to encourage "practical" education, partly by means of more objective testing of pupils.

16. Helpfully, the Institute emphasises the importance of pay relativities in creating incentives for training.

C.J. Mowl

C J MOWL

cm2a

	Treasury Budget	NIESR May
PSBR (£bn)		
1985-86	7	8¾
1986-87	7½	10¾
Fiscal Adjustment (£bn)		
1986-87	3½	0
World Trade in manufactures (%)		
1984	10	11
1985	5½	7
1986	4½	6
GDP (%)		
1984	2½	2½
1985	3½	3¼
1986	2½*	1¼
Inflation (%)		
1985 Q4	5	5¼
1986 Q4	4½ +	5
Current Account (£bn)		
1985	3	1¼
1986	3*	1½
MO (%)		
1985-86	3-7	6
1986-87	2-6	5
£M3 (%)		
1985-86	5-9	11½
1986-87	4-8	10½
Sterling Index		
1985	73-74	76
1986	73-74	75

* First half only

+ Q2 not Q4

PUBLIC SERVICES PAY IN THE 1980's

1. The NIESR article gives figures for settlements for selected grades of public servant over the years 1980 to 1985, and compares them with one another; with the movement in retail prices, and with settlements in the whole economy. It concludes that with the exception of the police, the main groups of public servants have had pay rises less than in the economy as a whole, and in some cases less than the increase in prices. It notes that in the past, such developments have been followed by "catching up" but that current government policies imply a continued widening of the gap.

2. The article also expresses puzzlement over how the pay factor is applied.

Comment

3. It is not possible to check the figures used in the article. The figures in the article are selective, choosing representative grades eg civil service clerical staff, rather than all public servants, and similarly selective in the settlements figure chosen (eg, not all civil servants got 5 per cent in 1984-85; not all nurses got 8 per cent). And the article concentrates on settlements, not earnings, thus excluding overtime, etc. Nonetheless, the broad pattern is probably reasonably representative.

Points

3 per cent pay factor?

It is the provision made in public expenditure plans for increases in central government employees' pay and allowances from due settlement dates. It is an important indicator of affordability,but does not predetermine settlements.

Figures in article accurate?

Difficult to judge. NIESR has selected individual grades within each public service group not average settlements for all members of the group. The comparisons look only at basic rates, not total earnings. They also exclude effects of recent Budgets in boosting take-home pay.

Government unfair/confrontational/discriminatory on public service pay?

No. Seeks low settlements throughout economy, based on what is needed to recruit retain and motivate staff and what the employer - ultimately taxpayer and rate payer - can afford. Different settlements for different public service groups reflect these factors.

Pay explosion in public services?

No sign of one in recent settlements, negotiations.

cm2

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CABINET OFFICE

70 Whitehall London SW1A 2AS Telephone 01-233 3299

From the Minister without Portfolio

The Rt Hon Lord Young of Graffham

Miss Janet Lewis-Jones,
Private Secretary to the
Lord President of the Council,
68 Whitehall,
London, S.W.1.

16th May, 1985

Dear Janet

PRESENTATION OF THE GOVERNMENT'S ECONOMIC AND SOCIAL POLICY

I attach a note of the meeting chaired by Lord Whitelaw yesterday.

I am sending copies to the Private Secretaries to the Home Secretary, Secretaries of State for Education & Science, Scotland, Wales, Environment, Social Services, Trade & Industry and Employment, the Lord Privy Seal, the Chief Secretary, the Chief Whip, the Paymaster General and to Bernard Ingham.

Yours ever

Leigh

Leigh Lewis
Private Secretary

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NOTE OF A MEETING HELD IN THE CABINET OFFICE ON 15th MAY, 1985, TO DISCUSS THE PRESENTATION OF THE GOVERNMENT'S ECONOMIC AND SOCIAL POLICY

(7th Meeting)

PRESENT

The Rt. Hon. Viscount Whitelaw
Lord President of the Council

The Rt. Hon. Sir Keith Joseph MP
Secretary of State for Education & Science

The Rt. Hon. Patrick Jenkin MP
Secretary of State for the Environment

The Rt. Hon. John Biffen MP
Lord Privy Seal

The Rt. Hon. Tom King MP
Secretary of State for Employment

The Rt. Hon. Peter Rees QC MP
Chief Secretary, Treasury

The Rt. Hon. Lord Young of Graffham, Minister without Portfolio

Mr. John Gummer MP
Paymaster General

Mr. Norman Lamont MP
Minister of State, Department of Trade & Industry

Mr. Raymond Whitney MP
Parliamentary Under Secretary of State, Department of Health and Social Security

Mr. Bernard Ingham
Chief Press Secretary to the Prime Minister

SECRETARIAT

Mr. L. W. Lewis
Miss S. E. Wallace

THE LORD PRESIDENT OF THE COUNCIL said that the Group would wish to take stock of the latest information on the impact of its work.

THE PAYMASTER GENERAL said that it was clear that the Government's point of view was being expressed much more frequently than before on local radio by both Ministers and backbenchers. The position with regard to regional television, though patchy, was generally much less encouraging. He would continue to take steps to try to improve the position.

THE LORD PRESIDENT OF THE COUNCIL said that he was also concerned that the current stories concerning the Social Security Reviews should be countered, in advance of the Reviews' publication, where they were wholly without foundation. Otherwise considerable damage might be inflicted on the Government's image irrespective of the accuracy of the speculation. In discussion, it was agreed that it would be difficult to counter each and every ill founded report in advance of the Green Paper being published. Nevertheless, it was important to rebut firmly any suggestion

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that the basic state pension was to be reduced as a result of the Reviews. THE LORD PRESIDENT, summing up the discussion, said that the Group were agreed that it would be useful to put out a note making clear that the Government had no intention of responding to every single allegation about the Social Security Reviews in advance of their publication but making the point also that there was no intention to change the basic state pension.

THE LORD PRESIDENT said that the Group would wish to consider the note setting out a proposed campaign to meet the criticism that the fabric of Britain was decaying. The campaign was intended in particular to dispel the myths that this was an expenditure cutting Government and that Britain was falling into decay because of alleged public expenditure cuts.

In discussion, the following points were made:

- There were dangers in the proposed campaign. In certain areas, such as education, it was undoubtedly true that buildings were less well maintained than had previously been the case. While this was partly due to LEAs spending money intended for repair and maintenance on teachers' salaries, it was nevertheless the case that it would be difficult to persuade the public that in some areas public provision was improving. It was also the case that, while spending on public sector capital projects had been broadly maintained in real terms at its 1980 level, that level was itself a considerable reduction on what had been spent in earlier years. It was important, therefore, that any campaign should not lose credibility by appearing to contradict a widespread perception of reality.

- On the other hand, it was clear that the Government's record on capital spending and investment was good in a number of areas, such as hospital building, roads, water and sewerage and railway modernisation. This achievement was not widely recognised and the proposed campaign could do much to remedy this. The achievements of other programmes such as urban policy and the Community Programme were also substantial and needed to be made more widely known.

- The emphasis in the note on building up the campaign locally and regionally was extremely important. People understood the effects of Government policy in their own community - e.g. a new hospital - whereas they were less convinced by figures of national performance. If information could be provided on the fruits of Government expenditure, regionally and locally, with hard and fast examples, this would do a great deal to aid backbenchers and others in getting over the Government's record on public spending.

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THE LORD PRESIDENT, summing up the discussion, said that the Group were conscious of the dangers associated with the proposed campaign. Nevertheless, there was a clear need to improve the presentation of the Government's case in this area and the campaign could be a major step forward in that respect. As a first response, information ought to be put together on spending by region and by locality. THE LORD PRESIDENT said that he would obtain such information in respect of two forthcoming regional visits which he was making and would seek thereby to obtain good local publicity. Based on that experience, the Group could consider extending the campaign more widely at a later meeting.

In discussion of other issues, the Group agreed that a background note might usefully be prepared on the forthcoming Green Paper on Higher Education; that in commenting on unemployment, Ministers should continue to stress the increases in employment; and that the Group would need in due course to consider the handling of the Government's study on local government finance.

Leigh Lewis
Cabinet Office

16th May, 1985

CONFIDENTIAL

CENTRE FORWARD GROUP: FRANCIS PYM ARTICLE — xref

Mr Pym called for:

i) **A reduction in employers' national insurance contributions.**

The Government agrees. It has cut national insurance contributions for employers by £4 billion since 1979. Recently the Oppostion spokesman on social security proposed raising the top rate to 13%.

ii) **More investment in infrastrucutre.**

In fact spending on national roads is 30% higher; capital spending on the NHS is 30% higher; £2.5 billion has been invested in railways since 1979 and £1.5 billion is planned in the next 3 years. Water investment is increasing by 20%.

iii) **A stronger regional policy.**

The Government agrees. The new regional policy announced by the SoS for Trade and Industry concentrates industrial aid more directly on the provision of jobs.

In addition Mr Pym calls for "a continuation of successful policies", such as the privatisation programme; the reform of trade union legislation; the encouragement of new businesses; the general stimulation of enterprise and much else.

On Labour

Mr Pym says:

"Labour is riddled with anti-democratic elements and saddled with policy commitments that would undo most of the good of the past 6 years."

On the Alliance

Mr Pym says:

"There are deep divisions and shortages of talent and experience."

14 May 1985

27:1

File

FROM: M T FOLGER
DATE: 14 May 1985

MISS O'MARA

cc Sir T Burns
Mr Monck
Mr Battishill
Mr H Evans
Mr Burgner
Mr Culpin
Mr Salveson (for No.10)
Mr Pickering
Mr Vernon
Mr H Davies
GB/04

ECONOMIC RECORD: TELEGRAPH ARTICLE BY MR PYM

As requested in your note of earlier this morning, I attach a quick note prepared by Mr Vernon and me.

MTF

M T FOLGER

"Conservative Centre Forward" group:

[[illegible] Pym's 14 May article in "Daily Telegraph"]

A. The record

Mr Pym claims:	Points for rebuttal
1. Growth: 3 per cent growth in real GDP in "5 years to 1984	- GDP up 3.8 per cent [ie nearly 4 per cent] between 1979 and 1984 - Between trough of recession, in first half 1981, and second half 1984, GDP up 9 per cent - ie annual rate of 2½ per cent. - despite coal strike, 1984 growth of 2½ per cent in line with EC average. OECD forecast UK to be fastest growing major country in EC in 1985, as we were in 1983. [1970-1982 UK bottom of growth league].
"Some regions grew, but only in southern England"	[True for 1979 to 1983] Since 1981, with only one exception (North) all regions have shared in recovery of output.
2. Manufacturing output "7 per cent lower [in 1984] than in 1979, 6 per cent lowre than in 1974	Yes manufacturing output still down from previous peak levels. [1984 level 8½ per cent down on 1979, 11 per cent down on 1974]. But note: - 1984 growth of mfg output 3½ per cent (biggest since 1973). - CBI April Survey showed strongest trend on orders since 1977

- manufacturing output in 3 months to February up 10 per cent on trough seen in first half 1981

- manufacturing output in relative decline for many years, services becoming more important:

- for example manufacturing output fell 2¾ per cent between 1974 and 1979

3. Jobs

"Despite recent job gains, unemployment has continued to rise."

Unemployment rising elsewhere in Europe too. And employment whilst rising in UK is still falling in major European countries:

- unemployment rose 1984 on 1983, in

  Germany
  France
  Italy
  Netherlands
  Belgium

- annual rates of change of employment, 83Q2 to 84Q4:

  France - 1½%(82Q4 to 83Q4)
  Germany -1%
  UK +1¾%

4. Industrial competitiveness

"British industry no more competitive than in 1979"

- IMF index shows manufacturing competitiveness 2¼ per cent better at 1984Q4 than at 1979Q4.

- Since 1981Q1 competitiveness has improved 23½ per cent.

- An inportant factor has been rise in manufacturing productivity -up 25½ per cent since 1981Q1.

"Productivity...has improved less than for many of our major competitors	- On OECD figures UK whole economy productivity rose 3¼ per cent a year 1980 to 1983. More than twice as fast as Germany or France.

B. Policy

"substantially reduce the employers' NIC"	- abolition of NIS already worth over £3 billion a year to private sector employers.
"provide greater encouragement to investment"	- 1984 Budget changes encourage better quality investment - CBI forecasts 8½ per cent rise in manufacturing investment in 1985, after 13 per cent rise in 1984 - 1984 investment across whole economy an all-time record, forecast to be exceeded in 1985.
"help to improve infrastructure and communications" "increase...investment in the public sector	big programme in hand - eg motorway maintenance, completion of M25. Since 1979-80 capital spending on motorways and trunk roads up 25 per cent in real terms.
"through greater retraining... help directly to reduce unemployment."	- Spent £1¾ billion on employment and training measures in 1984-85 alone - Major expansion of YTS and Community Programme in Budget will directly reduce unemployment by 150,000 in Spring 1987; 200,000 by Spring 1988.
"...develop an industrial strategy"	industry doing well without Whitehall picking winners (Concord). For example, chemicals output up 7 per cent over past year.

"...develop a coherent policy towards exchange rate"

- Government policy clear and unchanged: exchange rate important factor taken into account in assessing conditions.

4.76

FROM: MISS M O'MARA

DATE: 14 May 1985

cc Sir T Burns
Mr Monck
Mr Battishill
Mr H Evans
Mr Burgner
Mr H Davies

MR FOLGER

ECONOMIC RECORD

The Chancellor would be grateful if you could let him have as soon as possible a point-by-point rebuttal of the passage marked in the attached article by Francis Pym which appeared in today's Daily Telegraph.

2. He has noted that the Prime Minister will, of course, also need the main points of this for her briefing for Questions today.

MOM

MISS M O'MARA

Mr Butler

1. Mr Fletcher
2. File

ECONOMIC AND SOCIAL POLICY PRESENTATION

MEETING OF MINISTERS
APRIL 23, 1985

1. This note sets out for Ministers' consideration the next steps in the campaign to improve the presentation of the Government's economic and social policies and to win more credit for them.

Output

2. Annex I lists the background notes produced for circulation to members of the Government and members of Backbench Groups since the exercise began. In addition a note on the main trends in the economy is updated each month.

Policy Development

3. Annex II lists the main policy developments and events expected over the next few months.

Monitoring

4. There is some evidence from the COI of increased activity by Junior Ministers, especially in the West Midlands and North East of England. The extent to which Backbenchers are making use of the background material and putting over the messages, especially on local radio, remains unclear. There is similarly no clear impression of the extent to which the general policy messages, as distinct from particular issues, are being put over.

Looking Forward

5. One of the benefits of the campaign has been to identify and disseminate much more widely briefing on particular issues as they arise. Annex I shows that increasingly these are circulated by the Departments. This is a healthy development and much to be welcomed.

Yes, Prime Minister, there are alternative Tory policies

ON Sunday, the formation of Conservative Centre Forward was announced: a group of back-bench Conservative M Ps. Why has the group been formed, and what does it hope to achieve?

The group's nature lies in its name. We are committed Conservatives, determined to ensure the continuance of the Conservative Government. We belong to the central tradition within the party, sharing the values of "One Nation" Conservatism that have guided it for generations. We are looking forward to the future of the country and of our Government. We want to make a positive contribution to the direction of both.

It follows that we are firm supporters of the Government's objectives and of much that it has achieved. We agree on the problems that faced the country in 1979. We agree that the immediate enemy was inflation. It had to be reduced drastically. We are proud that it has been. We agree on the need for greater economic freedom. We have supported the privatisation programme and trade union legislation. We have applauded the Government's firm moral support to industry and the extension of wider share ownership. We will continue to support all these things.

There are many other substantial areas of positive support, from the encouragement of home ownership, to the strengthening of the police, to the firmness of our foreign and defence policies. Whenever the achievements on these issues have been threatened —as they were during the miners' strike—we have stood firmly in defence of our Government.

Where we differ

That is the context in which our variances should be viewed. Differences always tend to be highlighted, but let us keep them in perspective, and not forget the things that unite us.

So what are the differences? They concern not the objectives, but the policies designed to meet them. In our opinion, many of them have not worked. We need to ask two questions. Are we satisfied that our policies are achieving their objectives? If not, are we satisfied that we have fully examined the alternatives?

The most pressing issues concern the economy's performance on growth, employment and competitiveness. The facts make sorry reading.

In the five years to 1984, the gross domestic product grew by only 3 per cent in real terms. Without North Sea oil, which is a diminishing asset, there would have been virtually no growth at all. Some regions grew, but only in southern England. Manufacturing output was 7 per cent lower than in 1979 and 6 per cent lower than in 1974. Even allowing for the recession, it is hard to argue that this amounts to a successful recovery.

On employment, the figures are familiar. Despite recent job gains, unemployment has continued to rise. We came to power committed to reduce unemployment over time. Yet it is now nearly three times higher than in 1979.

British industry is no more competitive than in 1979. Productivity may have improved, but it has improved less than for many of our major competitors. In the name of competitiveness, we have endured the decimation of our industrial base, yet have emerged as uncompetitive as we started.

The facts speak for themselves. We do not blame the Government for everything, but the extent to which the policies have failed to match expectations is surely cause enough to re-examine alternatives with a more open mind. The Government's response has always been that there is no alternative. That response will no longer do. We believe there are three main areas of the economy where policies must be changed.

1. The Government should do more for industrial competitiveness. It should substantially reduce the employers' national insurance contributions. It should provide greater encouragement to investment. It should help to improve infrastructure and communications.
2. It should increase its investment in the public sector — in housing, public utilities and transport — and through this, through greater retraining and through a stronger regional policy, help directly to reduce unemployment.
3. The Government should intervene in those areas where its laissez-faire attitude has been most damaging. It should develop an industrial strategy. It should recognise the need for a partnership between itself, the unions and industry. It should develop a coherent policy towards the exchange rate.

Meanwhile, it should, of course, continue with its successful policies: the privatisation programme, the reform of trade union legislation, the encouragement of new businesses, the general stimulation of enterprise and much else.

Our policies are not a repetition of past mistakes. They are concerned with supply as much as with demand. However, they require that the Government should rewrite its medium-term financial strategy and adopt a less rigid attitude to borrowing. It is no longer convincing to say that such a step would rekindle inflation. We should remember that the American Government has borrowed hugely and has still achieved an inflation rate lower than Britain's.

Our views are not a minority opinion. They are broadly shared by many people active in the Conservative party; by a probable majority in the country; by most people in political life outside the Government; by an overwhelming majority of economists; by the CBI; by the senior management of major British companies like ICI and GEC; by the moderate leadership in the TUC; by the Secretary of the United States Treasury. The moral basis of these views is shared by almost all Church leaders.

That does not make the views right, but it means they should be heard with respect, and rebutted —if they can be rebutted — with cogent argument.

Conservative Centre Forward will try to convince the Government to adopt these policies. However, we are not just a pressure group on employment. Nor are we interested only in those areas where we disagree with the Government. We shall play a constructive part across the whole spectrum of issues, and we hope other Conservative MPs will join us.

What Britain expects

We are deeply concerned with the future of the Conservative party, and, considering the alternatives on offer, a continuance of the Conservative Government becomes even more imperative.

Labour is riddled with anti-democratic elements and saddled with policy commitments that would undo most of the good of the past six years. Within the Alliance, there are deep divisions and shortages of talent and experience.

And yet, with every new reminder of the failure of present policies, with every refusal to listen to other points of view, with every act of distance from the feelings of the British people, the Government is giving ammunition to our opponents.

The Conservative party is very loyal, and that is a great strength. It hesitates to criticise its leadership, especially when times are tough. In particular, the party quite rightly admires Margaret Thatcher for her courage and her determination to get things right again.

But good intentions are not enough. Brave words need effective action. And not all the action has been effective. The country expects the Government to modify some of its policies in response to mounting evidence that they are not working.

We accept that some will accuse us of disloyalty. That risk has to be taken. We do not feel disloyal. Rather, we feel that this is the right way for us to reflect widespread views in the party, and to be faithful to its best traditions.

6. This Ministerial Group's concern is to ensure that no gaps in this more detailed briefing arise, and that the briefing provided is used to effect. But its prime aim is to take a strategic view of presentation and to ensure that there is a steady flow of material which explains the Government's purpose and brings the strands of policy into a coherent whole.

7. Ministers will wish to consider, in the light of Annex I, which topics/events in Annex II call for background notes.

8. But their main concern will be to examine which strategic issues need to be attacked. This paper suggests there are three immediately:

i. to put over the country's success in generating new jobs (Annex III);

ii. to take credit, in an acceptable way, for the collapse of the miners' strike and what it could mean for the British economy (Annex IV);

iii. to demonstrate that the Government is not running out of steam and has significant and important tasks ahead to the next General Election (Annex 5).

Summary

9. Ministers are invited to comment on:

- the balance and adequacy of background notes so far published (Annex I)
- forthcoming issues which call for background notes (Annex II)

- whether the proposed background notes (Annexes III-V) serve their strategic purposes

- the impact which the campaign can be demonstrated to be having, or its perceived effects.

BERNARD INGHAM
18 April 1985

ANNEX I

THE FOLLOWING BACKGROUND NOTES WERE ISSUED BEFORE APRIL 3

- Public investment versus tax cuts (18 January 1985)
- Public expenditure (29 January)
- Pay bargaining - need for moderation in pay settlements (4 February)
- Education expenditure (4 February)
- Bus de-regulation (22 February)
- Government record since 1979 (22 February)
- Social Trends (1 March)
- Teachers' pay (updated regularly and distributed by DES) (1 March)
- Rate capping (distributed by DoE)
- Local authority capital expenditure (distributed by DoE)
- National Health Service (distributed by DHSS)
- Budget note (March 19, distributed by Treasury)
- Government achievements since 1983 General Election (March 20)
- Creating an environment for enterprise (March 25)
- Better schools (March 26)
- Employment White Paper (March 29)
- Enterprise and Jobs (April 2)
- Education and training young people (April 2)

ANNEX II

MAIN POLICY DEVELOPMENTS/EVENTS OVER NEXT FEW MONTHS

Policy Developments

- Liberalisation of shop hours (Commons debate soon)
- Public Order Review (White Paper, late April)
- Family Practitioner Service (Green Paper, early May)
- Home Improvement Grants (Green Paper, early May)
- FA/Football League proposals for dealing with soccer hooliganism (early May)
- Defence White Paper (early May)
- Pay Review Body reports (soon)
- Social Security Review (May)
- Airports policy (June/July)
- Licensing hours (late summer)

Major Events

Economic Summit, Bonn (May 2-4)
Prime Minister' BBC Radio 4 "World this Weekend" broadcast (May 5)
VE Day Commemoration service (May 8)
Prime Minister at Scottish Conference (May 10-11)
Chancellor Kohl visits Chequers (May 18)
Prime Minister addresses Conservative Women's Conference (May 22)
Prime Minister addresses American Bar Association (July 15)

ANNEX III

UK EMPLOYMENT - SOME FACTS

i. The number of people in jobs increased by 343,000 over the year to 2 December 1984 and by 613,000 in less than two years (about 350,000 self-employed and 250,000 employed). Latest figures show that this trend is continuing.

ii. The United Kingdom is seeing employment grow at twice the rate in Japan while in Germany and France it is still falling.

iii. The number of jobs created by inward investment is increasing - nearly 30,000 in 1984, an increase of 86% over 1983.

iv. The proportion of population of working age in work is higher in the UK (65%) than in West Germany (59%), France (61%), Italy (55%), and comparable to that in the USA (66%).

v. The number of businesses in the UK increased by over 100,000 between the end of 1979 and 1983.

18 April 1985

ANNEX IV

THE COAL STRIKE IN RETROSPECT

It is well over a month since the coal strike ended (March 3), and a more objective assessment of the outcome is now possible.

In financial terms everyone was a loser. The cost in 1984-85 was £2,500-£2,750m in terms of public expenditure and borrowing. This works out at £50 for every man, woman and child in Britain.

This massive cost to the taxpayer is made up as follows:

- £750m damage to the coal industry
- £1,250m for burning extra oil in power stations
- £250m for keeping the peace - ie the police operation
- £250m for the extra costs to British Rail and British Steel
- £250m for sundries, such as tax loss.

It works out at £100 for every taxpayer - a cost incurred in spite of the best offer ever made to the miners' union in terms of pay, investment in the industry and early retirement/redundancy provision.

But the biggest losers were the miners themselves - their loss in pay averaged £9000 per head over and above other costs, such as additional debt, which their leaders led them into.

And for what? For no more pay. For no better conditions. And for no greater security, for the strike itself closed scores of faces and rendered unprofitable pits even less profitable.

This then was the classic post-war demonstration of the futility of striking.

It will be a great gain for Britain if organised labour increasingly recognises - and there is some evidence that the point is sinking in - that strikes are an outmoded, expensive, unreliable and often counter-productive weapon.

Such a widespread recognition would be the best news yet for the unemployed. Nothing is more likely to win us orders abroad for competitive products than a new feeling among our customers that we can be relied upon to deliver on time.

The British economy did in fact come through the strike in remarkably good shape. That points to its underlying strength. Now that the strike is over the economy will grow faster and that is more good news for those seeking work.

But there are other benefits not merely from the ending of the strike but from the actual dispute itself.

First, Britain beat off a severe and violent challenge to Parliamentary democracy. The declared aim of the leaders of the strike was the overthrow of the Government. This failed because the country was determined it should not succeed and gave overwhelming support to the police - the forces of law and order. Our Parliamentary democracy will be the stronger for this.

Second, the British trade union movement as a whole, and in particular the third of the miners who bravely stayed at work, demonstrated they would have no truck with the NUM leadership's manipulation of its members into a strike. The NUM's refusal to ballot its members cost it massive potential support.

Third, the willingness of the NUM's leadership to look

abroad for help, and not least to Libya and Russia, spoke volumes to ordinary people of their revolutionary nature. And it revolted them.

Fourth, the NUM leadership's refusal to contemplate the closure of uneconomic pits, whatever the cost, was generally seen to be an unrealistic attempt to hitch a permanently subsidised ride on the back of the taxpayer - a taxpayer who was already, before the strike, subsidising the coal industry to the tune of £1,300m.

Fifth, the unreasonable demands of the NUM's leadership not merely angered taxpayers; it also alienated trade unionists who had had to settle for much inferior terms, especially redundancy payments when the recession caused their firms to close. The strike also demonstrated, sometimes cruelly to workers in firms supplying the coal industry, our interdependence in a modern economy. And it heavily underlined the truth that strikes cost jobs.

The coal dispute not only exposed the futility of striking; it also demonstrated the practical relevance of the law to trade union affairs and industrial relations - areas which for too long had been seen as rather outside, if not beyond, the law.

It may well be that this - the very opposite of what the NUM leadership intended - will prove, for ordinary trade unionists as well as the trade union movement generally, the greatest uncovenanted bonus of a wholly unnecessary dispute.

ANNEX V

GOVERNMENT ACHIEVEMENTS - AND TASKS AHEAD

It is becoming fashionable to suggest that the Government, "having conquered inflation and the trade union problem", now stands in need of great issues with which to inspire the public in the run up to the next election.

This view does at least illustrate the Government's success in dealing with two of the greatest scourges it inherited from the 1970s - namely rampant inflation and rampant trade union power.

But it also overlooks a problem which confronts not only Britain but virtually all advanced industrial countries - namely, unemployment. The conquest of unemployment, on the basis of sound and prudent financial and economic policies, remains the Government's great purpose.

Substantial progress has been made, not least with the control of inflation. But the recent rise in the Index of Retail Prices to just over 6% shows that, even though there is no risk of inflation taking off, we have still a long way to go before we match the achievements of our major competitors - USA, Germany, Japan - let alone squeeze it out of the system.

Until we match or better the low inflation rates of our major competitors, we shall be at a disadvantage in our home and export markets to their goods and services. And that means we shall be creating fewer jobs in Britain than we otherwise might be doing.

This shows how closely inflation and jobs are connected. The lower our inflation the more jobs we are likely to create.

The conquest of unemployment, the squeezing of inflation and the encouragement of moderation in trade unions are part of this Government's unfinished business.

But they are, in fact, only facets of the Government's overall purpose - to create a much more enterprising, entrepreneurial, dynamic and flexible society. A host of policies, which remain to be carried forward, are directed to this end:

- tax reductions on companies, not the least of which was the abolition of the National Insurance Surcharge worth £3bn a year to British industry and commerce

- privatisation (or denationalisation, as it used to be called) to stand major industries on their own two feet instead of allowing them to rely on the taxpayer

- removal of unnecessary burdens - red tape, regulations restrictions on job creating companies, and especially small firms; the current search for an alternative to the present rating system is, in industrial terms, part of this drive

- a wide range of help and encouragement for all who want to go into business and create employment

- the promotion of a property owning democracy with an increase so far since 1979 of 1.8m in the number of home owners (most of them buyers of council houses) and share ownership (especially through the British Telecom share flotation shared by 2 million buyers)

- switching resources - £90m since 1982 - in further and higher education to produce more engineers and technologists

This does not exhaust the measures applied in pursuit of the strategy of a more enterprising society.

You can't, for example, have a more enterprising society unless our schools prepare people for it. And for too long our schools have been thrusting unprepared youngsters (through no fault of their own) on to the labour market.

So, another of the great tasks of this Government is to raise the standards of education in Britain so that every pupil is given the best chance in life that his innate abilities allow. A great drive is now on to raise the standard of education and achievement in our schools. We owe our children no less.

Other tasks ahead of this Government are:

- to complete the biggest review of our social security system since the Beveridge report (Nov 1942) which heralded its introduction; how can we reconcile the concept of help where it is really needed - the safety net principle - with a more dynamic, productive society?

- to reform the inequitable and indefensible rating system

- to play our part in developing the European Community, as a major area of democracy and stability in the world; and to complete the common market within it, with all the opportunities that presents Britain's financial and service industries

- to promote peaceful co-existence, wider understanding and a much lower level of armaments, on a balanced and verifiable basis, as a loyal member of the Atlantic Alliance.

There is thus no shortage of great issues to inspire the public during the second half of this Government's second term.

It is engaged upon a comprehensive effort to modernise and galvanise Britain in the interests of the well being of both the British people and international relations. We shall be more successful internationally the more successful economically we are at home.

The two go together. And this Government's strategy recognises that.

R12

CONFIDENTIAL

Prime Minister ②

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

Robin Butler Esq
10 Downing Street
London SW1

9 April 1985

Dear Robin,

The Prime Minister will wish to be aware of the economic assumptions Treasury Ministers have in mind for use in the report of the Government Actuary (GA) on the social security benefits uprating order (to be published around the end of June), and in the Public Expenditure Survey.

The main assumptions are summarised as follows:

MAIN ECONOMIC ASSUMPTIONS

	Unemployment (million)	Prices (per cent rise to May)	Average Earnings (per cent rise year on year)
1985-86	3.0	6¼	7¾ (7)*
1986-87	2.9	4½	6
1987-88	2.85	3½	5
1988-89	2.8	3	4½

*Figure in brackets is for underlying earnings growth, ie adjusted for the effect of the coal strike.

The only assumptions to be published at this stage will be those for unemployment and earnings for 1985-86. They will be contained in the GA's report, and are underlined in the above table. For prices, the report will be based on the actual May RPI figure to be published in June.

For unemployment, the figure that it is proposed to publish is an average 3.0 million unemployed (GB narrow definition, ie excluding school leavers) in 1985-86. This is the same as the assumption published in the GA's November 1984 report. The Treasury's economic forecast completed just before

the Budget had figures for unemployment of 2.97 million in 1984-85 and 2.98 million in 1985-86. The figure quoted by the Government Actuary is normally rounded to the nearest 0.1 million or, occasionally, to the nearest 0.05 million. On either convention, the Treasury forecast for 1985-86 rounds to 3.0 million.

In the past the unemployment assumptions have normally shown a flat path for unemployment in later years; following this tradition, the assumption would be for unemployment to stay at 3 million in later years. The assumptions that Treasury Ministers are now proposing to issue allow for a decline in unemployment in the years after 1985-86. For 1986-87 and 1987-88 this decline in unemployment reflects the expenditure measures announced in the Budget (YTS and the Community Programme). This means that the public expenditure projections in the PES will take credit for the effect that these measures will have on social security expenditure, as the FSBR forecast of public expenditure did.

Figures for unemployment in the years after 1985/86 are not published at this time of year and the unemployment assumptions will be reconsidered in October before publication. We will, of course, keep the Prime Minister in touch with the proposals that Treasury Ministers then have.

For earnings, it is proposed to give the Government Actuary a figure of 7¾ per cent growth in 1985-86. This is affected by the return of earnings in the coal industry to a more normal level, following the end of the coal strike. The Government Actuary will be asked to give prominence, as he did in his November 1984 report, to the underlying figure for average earnings growth (ie excluding strike effects), which would be 7 per cent in 1985-86.

The figure for earnings growth in 1984-85 that he will publish will be 6½ per cent (estimated outturn), equivalent to an underlying 7¼ per cent. Thus his figures will show a small decline in underlying earnings growth between 1984-85 and 1985-86. This means a slight change from the November 1984 report when the Government Actuary gave a figure of 7½ per cent underlying growth in 1984-85, followed by 7 per cent in 1985-86.

Yours ever
Rachel.

RACHEL LOMAX

5

Ref. A085/492

PRIME MINISTER

Economic Strategy

FLAG A (C(85) 4)

BACKGROUND

In C(85) 4, the Chancellor of the Exchequer seeks the views of his colleagues on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1985-86, and on the broad shape of a Budget with an employment theme.

2. Although the Chancellor of the Exchequer will take the views of his colleagues into account in preparing his Budget, he will not wish to be bound by them. He will also want to avoid any commitment to further collective discussion during the run-up to the Budget on 19 March, though he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

3. There are a number of major uncertainties about economic trends, which make preparation of this year's Budget unusually difficult:

a. The outlook for oil prices and the sterling exchange rate remains clouded. Since last summer the fall in the pound/dollar exchange rate has been greater than the reduction in the realised dollar price of North Sea oil, so that oil revenues have exceeded earlier forecasts, and are projected to continue to do so. A further fall in the dollar price of oil, or a sharp recovery of sterling against the dollar, could have a substantial effect on the Budget arithmetic.

BRIAAN

b. The miners' strike reduced output by 1 per cent in 1984, as well as reducing the current account surplus by £2½ billion. An early end to the strike would have a favourable direct impact on UK output and the trade balance, and seems likely also to have a favourable impact on the financial and foreign exchange markets.

c. Recent movements in the sterling exchange rates and in UK interest rates have been greater than the forecasters would have expected. There has probably been some over-reaction in the markets, which could well be corrected at some point during the next few months. Meanwhile, however, the effect of these movements is bad for inflation, and their reversal within a given time-scale cannot be relied on; it is perhaps noteworthy that the pound/dollar rate has not yet responded to the tightening of the market (spot prices for North Sea oil have risen by $1.50-2.00 a barrel over the last two weeks). The prospect substantially depends on the course of US fiscal and monetary policy, and on worldwide market sentiment toward the dollar; neither can readily be predicted.

d. Private sector pay settlements during the current wage round have so far been about half a per cent higher than last year, and unit labour costs have been rising. No significant public sector settlements have yet been concluded, but the indications are that it will be difficult to prevent an increase above last year's levels. This could add to the difficulty of public expenditure control.

4. Despite these uncertainties, the performance of the UK economy has in a number of ways been reasonably good. The increase in Gross Domestic Product (GDP) in 1984, at 2½ per cent, compares with last year's forecast of 3 per cent; allowing for the impact of the miners' strike, underlying growth may have

been somewhat higher than expected. The current balance has remained in surplus despite the deterioration on oil account caused by the strike. Inflation has remained at or below 5 per cent despite the continuing depreciation of sterling (where the effective exchange rate index has fallen from 90½ in 1982 to about 71 today). Company profits and cash flow have remained relatively good, and the outlook is for rising industrial investment despite recent increases in interest rates. But the trend in unemployment has remained stubbornly upwards, despite the sharp slow-down in productivity growth.

MAIN ISSUES

5. The main issues are:

a. the level of the PSBR in 1985-86;

b. the balance as between personal, indirect and company taxation;

c. the nature of any fiscal adjustment, bearing in mind the Chancellor's objective of presenting a "Budget for jobs".

The level of the PSBR in 1985-86

6. At the time of the 1984 Budget, the forecast of the PSBR for 1984-85 was about £7.25 billion (with the Budget changes having a broadly neutral effect on the financial year immediately ahead). The Chancellor's Autumn Statement - on the assumption that the miners' strike would be over by the end of 1984 - put the figure at £8.5 billion. It is clear that the out-turn will be substantially greater, with borrowing approaching the 1983-84 level of £10 billion. A substantial part of the excess is directly attributable to the miners' strike, but there are indications from recent experience that

BRIAAN

the Treasury model may be tending to understate the PSBR: this factor would tend to reinforce the Chancellor's judgment that the objective should be to return to the Medium Term Financial Strategy (MTFS) path of holding the PSBR to 2 per cent of GDP, or about £7 billion.

7. Some Ministers may put forward arguments on the following lines in favour of a more relaxed fiscal stance:

a. US experience has combined vigorous real growth, continuing low inflation, a high PSBR, and an appreciating exchange rate. The attractions of a dynamic economy, and of the high interest rates required to finance public borrowing, have outweighed any adverse impact of the high PSBR and current account deficit. While the UK cannot expect fully to emulate the US example, the market response to expansionary Budget measures clearly perceived to encourage growth and enterprise might be quite favourable.

b. Reducing the PSBR to 2 per cent of GDP would represent a sharp contractionary move as compared with the 1984-85 situation, when the PSBR is likely to be around 3 per cent of GDP. The UK economy has absorbed this year's overshoot without excessive damage.

c. The eventual success of the Government's policies in revitalising the UK economy depends on their attracting and retaining the widest possible public support. Support could be increased by giving more people a feeling that the battle was being won.

8. The Chancellor may draw on some of the following arguments in reply:

a. Domestic demand, including both private consumption and investment, is projected to grow by 3 per cent in real

terms, on the basis of a "neutral" Budget (ie allowing only for the indexation of direct and indirect taxes).

b. The underlying fiscal stance to which the bulk of the economy has adjusted is that which excludes the impact of the miners' strike.

c. Upward pressures on public expenditure, particularly if the strike were to drag on, could prove very difficult to contain.

d. The £½ billion increase projected between 1984-85 and 1985-86 in receipts from special sales of public sector assets implies some underlying relaxation in fiscal stance not reflected in the PSBR numbers.

e. Adverse market reactions to a perceived fiscal relaxation - if they were to materialise - could have very damaging effects on inflation and on confidence in future UK economic growth.

9. Present indications are that a neutral Budget would result in a PSBR for 1985-86 of around £6-6½ billion, ie that there would still be room for some small fiscal adjustment within the £7 billion implicit in the MTFS figure of 2 per cent of GDP, but less than the £1½ billion contemplated last autumn. It might be reasonable to aim on balance for the £7 billion figure, accepting some risk of it being overshot because of the miners' strike and other public expenditure pressures.

Balance between taxes

10. The main elements in last year's Budget were:

a. a real (ie beyond indexation) increase in income tax allowances and thresholds costing about £1 billion in 1984-85 and £1½ billion in a full year;

b. corporation tax changes, reducing capital allowances and tax rates on a broadly self-balancing basis;

c. halving of Stamp Duty, at an annual cost of around £½ billion;

d. abolition of the national insurance surcharge (NIS) paid by employers, from 1 October 1984, costing £0.3 billion in 1984-85 and nearly £1 billion in a full year;

e. widening the VAT base and a real increase in excise duties, yielding £0.6 billion in 1984-85 and £0.9 billion in a full year;

f. a once-for-all change in the timing of VAT payments, yielding £1.2 billion in 1984-85 but nothing thereafter.

11. The Government's objective of revitalising the economy might be thought to suggest further moves to reduce the burden of taxation on companies. However, with the abolition of NIS and the change in the structure of corporation tax (which removed the bias in favour of capital rather than labour-intensive production methods), the scope for further major structural shifts is limited. It is perhaps significant that neither the Secretary of State for Trade and Industry nor the Minister without Portfolio have in their pre-Budget letters to the Chancellor suggested any changes in business taxation

which would have a major macro-economic impact. There could still be advantage in a further shift from direct to indirect taxes, which has been a feature of the Government's policy; such a move would in principle add to the resources at the Chancellor's disposal to increase tax allowances and thresholds by more than indexation, but it would have the disadvantage of increasing the rate of inflation at a time of stronger upward pressure from recent exchange rate and interest rate movements. Meanwhile the prospect is that last year's Budget changes will in any event put £1.7 billion more into taxpayers' pockets in 1985-86 than would have happened had that Budget been confined to simple indexation of direct and indirect taxes. It would clearly be desirable to reduce the burden of direct taxes (including national insurance contributions); payments of direct taxes as a proportion of gross earnings are projected to remain well above the proportions current in 1978-79 for all except those on twice average earnings and above. But the present high proportion of incomes taken in taxes reflects in large measure the need to finance benefits for 2 million additional unemployed since 1979 and their dependents in a non-inflationary way.

A Budget for jobs

12. The Chancellor does not say what he has in mind in terms of specific measures to encourage employment. These could fall into five broad areas:

a. Specific measures - each costing a comparatively small amount - to encourage particular activities or industrial sectors (examples might be some extension of the loan guarantee scheme, amendments to the Business Expansion Scheme, charging only the basic rate of income tax on undrawn profits of unincorporated traders).

BRIAAN

b. Tax changes to encourage employers to take on additional - probably lower paid - workers. (The change in the contribution structure put forward for consideration by MISC 111 could have something of this effect, but there is unlikely to be scope for any further general reduction in employers' national insurance contributions following the abolition of NIS.)

c. Tax changes to increase incentives to work and alleviate the poverty trap. Such changes would involve real increases in tax thresholds, so as to reduce the marginal tax rates faced by lower paid workers as their incomes rise and their entitlement to welfare benefits tapers away.

d. Expenditure changes to reduce the impact of the poverty trap. Here again the work of MISC 111 is relevant. An increase in Child Benefit not matched by an increase in Supplementary Benefit children's scales would have the effect of directing help towards the families of people in lower paid work.

e. Expenditure changes which directly reduce unemployment. Extension of youth training opportunities (currently under discussion in MISC 107) might be an example of this. Permitting some increase in numbers employed in lower-paid, and low resource consuming, public sector work, where employment, supervision and materials costs were not very much more than entitlement to social security benefit, might in principle be another; but in practice the scope for this (other than in the context of youth training) is likely to be very limited indeed.

BRIAAN

Medium Term Financial Strategy

13. The Chancellor (paragraph 10 of C(85) 4) essentially proposes adhering to the MTFS as already formulated, but without extending it beyond 1988-89. The Government's public expenditure plans continue to provide for expenditure to be held constant in real terms at the level projected for 1986-87; and monetary targets would be maintained on the basis established last year. With all the uncertainties surrounding the present economic situation, there seems to be nothing to be gained by extending the time horizon beyond four years; but equally there is every reason to stick to the MTFS as it is now, in order to maintain confidence in the Government's determination to achieve its objectives.

HANDLING

14. After the Chancellor of the Exchequer has introduced his memorandum, you may wish to divide the discussion into two parts:

i. the overall fiscal stance, and the size of the 1985-86 PSBR;

ii. the more detailed shape of the Budget, and the relevance of the jobs theme to particular possible measures.

You may wish to ask the Chancellor of the Exchequer to respond separately to each part of the discussion.

CONCLUSIONS

15. In your concluding remarks you will wish to avoid any suggestion that the Chancellor of the Exchequer is committed by the discussion to particular changes in his Budget, and to avoid

any commitment to further general discussion by the Cabinet, apart from the traditional meeting immediately preceding the Budget.

16. You might then record conclusions which:

i. invite the Chancellor of the Exchequer to take account of the views expressed in discussion in his further work on the Budget;

ii. invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer.

RGA

ROBERT ARMSTRONG

13 February 1985

BRIAAN

R10

COVERING SECRET

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

Andrew Turnbull
10 Downing Street
London SW1

7 February 1985

Dear Andrew

FORECAST REPORT

The report by officials on the Treasury's latest economic forecast has recently been completed. At this stage this is an internal report only: a version for publication in the FSBR will be considered later.

... I enclose three copies, for yourself, Robin Butler and John Redwood.

51 JR
52 FERB
53 AT

Yours ever
Rachel

RACHEL LOMAX

INSTITUTE OF DIRECTORS

From the Director General

Prime Minister
In total not as unhelpful as you might think from reading the first paragraph.
FERB 7.2.

Director General
Sir John Hoskyns

PERSONAL AND CONFIDENTIAL

7th February, 1985

The Rt.Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London S.W. 1.

It is the customary rant.
No presumption not

116 Pall Mall
London
SW1Y 5ED
Telephone
01-839 1233
Telegrams
Boardrooms
London SW1
Telex 21614

Dear Margaret,

We have been doing some thinking here about the main issues confronting the Government in the longer term and three articles will be published in The Times over my name next week. We have picked the brains of Douglas Hague, Pat Minford, Lionel Bloch (one of the key people on the original CPS Trades Union Reform Committee), John Kay of IFS and others. The aim of the articles is two-fold: first, to set out some relevant thinking for government; and second, to try and straighten out the confused thinking amongst the Government's critics and quite a few of its own back-benchers.

I enclose a copy of the first article - in draft form, and not proof read - which will come out on Monday on the Features Page of The Times, with further articles planned to appear on Tuesday and Wednesday, we believe.

Yours ever

John

John Hoskyns

CHAPTER 1 - SETTING THE SCENE

INTRODUCTION

Despite an unusually long period of financial stability and gradual recovery, and well before the recent slide in the oil price and the pound, doubts about any kind of British economic miracle were already on the increase. Continuing tactical crises, so familiar in the sixties and seventies, are now less frequent. But the post-war strategic crisis - the long process of national decline and fall - remains. It is unlikely to be surmounted on present policies.

Labour costs are once again rising in this country, while they are static or falling for our main overseas competitors. The problems of unemployment and public spending still seem insoluble. The financial burden of supporting the retired population, and especially the very old, grows heavier. State pension payments as a proportion of total UK personal income have more than doubled in the past 20 years and the percentage is likely to grow by nearly half again over the next 15 years. The working population has increased by one million since 1970 (400,000 since 1979) and will grow by a further half million by 1990, and there are no signs of unemployment falling. All-embracing welfare provision appears to undermine the economic process necessary to support it. The hidden economy grows, as people migrate to a non-taxpaying regime. Any suggestion of radical change runs into opposition from vested interest groups, which, seeing no sign of an economic miracle, cling grimly to what they hold: home owners, parents, council employees, business interests, trades unions, professions, farmers, and the MPs who represent them.

The preservation of "today" - and, indeed, yesterday - remains sacrosanct and tomorrow is regarded as expendable. In this deadly negotiation between the present and the future, the first-order problems are scarcely discussed: the £40 billion of social security spending, much of which is effectively demand-determined and thus uncontrollable; the economic effects of welfare in all its forms; the growing cost of the health service; the poverty and employment traps which block the escape from unemployment into paid work; the economic costs of collective bargaining and employment protection; the tax burden on the low and/or average paid; indexation; the right, in practise, to be paid for declining to take available work. These problems interact together with enormous power. Most of them are consequences of patchwork policy-making by past governments. Many are the results of specific pledges given by by politicians under pressure. Together they imprison governments in what appears to be an inevitable historical process of decline. The "policy box" in which ministers are at present locked is too small to contain any solutions.

THE GOVERNMENT'S ACHIEVEMENTS

Paradoxically, it is the relative success of government since 1979 which brings these problems into our range of vision. Memories are short and people already forget the years when governments lived from crisis budget to crisis mini-budget. Already we take for granted the fall in inflation, the defeat of public sector strikes, the reduction in trade union power, the slimming of the Civil Service, the huge programme of denationalisation, the removal of all those hopeless controls and regulations - prices, dividends, profit reference levels, exchange controls, pay norms. All this has been done in the wake of the 1979 doubling of oil prices. We forget that in 1976 the Government was borrowing today's equivalent of nearly £30 billion and inflation was over 25%.

We forget the days when the growing tax burden on the average worker was sold back to him as "the social wage", and concern about trade union disruption routinely dismissed as "reds under the bed". Because previous governments were always fire-fighting, they never confronted the country's central dilemma: our unsustainable post-war political economy. The present government, despite all its inevitable mistakes, is the first to to reach the threshold of the Augean stables. Its predecessors were swept away, exhausted and discredited, before they even got to the stable door. Today, we ask whether the government is capable of long-term strategy. We never asked the same question of its predecessors because they were burnt out long before the question arose.

CAN WE AFFORD UNDERKILL?

Where is this country trying to get to? Where would unchanged policies take us? What are the likely long-term consequences of a cautious strategy of "consolidation"? Might the political and social tensions arising from further radical change undo the likely benefits? What do we mean by lasting recovery? Political and economic stability as a sort of "second world" economy? Or a true reversal of a hundred years of decline? Is the latter possible, or is decline now programmed into the British character? It is a matter of risk analysis. The penalty for overkill - that is, developing a programme which turns out to be more radical than was necessary - may be less than the penalty for "underkill", the more familiar British tendency to do too little, too late. If we conclude that settling for a quiet life now may produce unquiet lives for our children, then we have a duty to make policy on worst case assumptions. If, on the other hand, we conclude that a radical programme is simply not possible, then we had better concentrate our minds on how to preserve political stability with continued relative decline. But this has,

of course, been the establishment posture for most of the post-war period up to 1979, and the results to date are not encouraging.

I believe that the government must err on the side of overkill. If other industrialised economies were in a similar state to our own, we could afford complacency. We would all be equal and all relatively poor. But that is not the case. It is true that there are signs of the British malaise in other European economies, and that they too are beginning a painful reappraisal. But we start from a long way behind. Perhaps more important, our cumulative "policy configuration" may have made our economy inherently unstable, so that the mechanisms by which it adapts to change and external shock threaten to break down under stress.

THE DECLINE OF RATIONALITY

The present government - radical enough by post-war standards - operates in a hostile intellectual climate, shaped by governments which generally took the line of least resistance. It is a climate which makes rational thought difficult. All actions are judged in terms of conduct today, rather than results tomorrow. Symptoms are treated as causes. Those who propose painful measures are accused of wanting them for their own sake. It is a world of moving goalposts, with little awareness of causes or consequences, no comparison with the past, or with the experience of other countries. There is a total unawareness of secondary economic effects. The teaching of what Lord Bauer has called "priceless economics", has reinforced the widespread belief that "in today's complicated world, the market no longer works" , which has led to policies that have harmed millions.

It requires great courage for Ministers to speak the truth in such a climate. Courage requires convictions which are the fruit of intellectual effort, not of blind faith. It is not the job of civil servants to develop such convictions (they must, after all, stand ready, at the limit, to serve a Marxist government if one is freely elected), while ministers simply do not have the necessary thinking time. This is why they so often find themselves describing objectives for which they are unable to devise measures, or committing themselves to measures whose consequences they are cannot predict.

We all know, now, that there is an ideological battle between those working for stability and recovery and a minority which, to put it plainly, hates Britain, hates the United States, supports the Soviet Union and wishes to destabilise the democratic system. But there is also an intellectual civil war - perhaps even more dangerous - within the establishment, between those who know that time is running out and who feel the impulse to go back to first principles and think the problem through; and those who prefer the status quo or are simply too tired to go on thinking at all. To an alarming extent, those who are prepared to make the effort are outside Whitehall and Westminster, rather than in. As Mr. David Hart has pointed out, in a recent article on these pages, the "will to lose" is firmly established.

Businessmen are sometimes part of this problem. Like politicians and civil servants, they have organised themselves for coping with the present state of affairs. By the time they are in their mid-forties, many of them will have looked around and concluded that Britain, however sickly, "will see me out". If enough people, in and out of Whitehall, think like that, it probably won't.

SO WHAT DO WE DO?

The Thatcher government's first term concentrated on financial stability: the control of inflation, public expenditure and borrowing, public sector pay and the first steps to reduce union power. Now, everyone is beginning to talk about secondary issues of the "we must" variety; we must increase the number of engineers; we must make education more responsive to industry; we must improve our product design; harness our national research effort more closely to industry; change public attitudes to the wealth creation process, be more entrepreneurial and so on. There is nothing wrong with these ideas, all of which merit early attention, provided they can be translated into policy rather than remaining worthy aspirations. But there is an entire and crucially important phase missing: economic stabilisation.

We still need a quiet revolution on every aspect of our present policies for spending, taxing, working, earning and "caring". This is, I believe, recognised more clearly by outside policy groups than it is in Whitehall and Westminster. In this wider and intellectually richer world, party-political viewpoints are becoming less relevant. People starting from different political positions are brought closer together by their analysis of Britain's problem. Instead of being separated by ideology, intellectual honesty forces them to an increasingly shared understanding of the enormous problem facing the country. But it will not be enough for outsiders to present analysis and prescriptions. They have first to persuade the official and elected policy makers to think in a different way, and to look at an uncomfortably different agenda. These articles are intended to start that process.

File ECL

10 DOWNING STREET

From the Private Secretary 25 January 1985

National Savings

The Prime Minister has seen your letter to me of 23 January and agrees with the proposals for increased rates on National Savings instruments.

(Andrew Turnbull)

Adrian Ellis Esq
HM Treasury

CONFIDENTIAL

ECL

242/59

CONFIDENTIAL

Prime Minister (1)
Agree?
AT 23/1

Treasury Chambers, Parliament Street, SW1P 3AG

Yes mT

A Turnbull Esq
10 Downing Street
LONDON SW1

23 January 1985

AT/ told E.S.T's office.

Dear Andrew

NATIONAL SAVINGS

As you know, the Council of the BSA has responded to the recent increases in bank base rates by recommending, inter alia, a ¾ per cent increase in building society deposit rates. The Nationwide, Woolwich, Halifax and Leeds Societies have announced their intention to implement this recommendation and it seems likely that the rest will follow suit.

We have concluded that National Savings rates should also be increased broadly in line with building society rates. The current and proposed new rates are:

	Current	Proposed
Income Bond	12.0%	12.75%
Deposit Bond	12.0%	12.75%
Invac	11.25%	12.25%
Certificate	8.0%	8.85%

The income and deposit bond rates, which are gross of tax, will be increased by slightly less than the increase in building society rates; a comparable increase to 13.0 per cent would take these rates to a record level and would look particularly agressive in the run-up to the introduction of composite rate on banks. But to compensate, the rate on the Certificate (which is paid net of tax) will be increased by slightly more than the ¾ per cent building society rate increase. In addition, the rate on the Yearly Plan will be increased from 9.06 to 9¼ per cent.

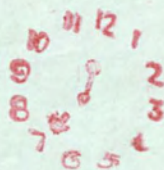
In the nine months April to December, National Savings net inflows amounted to £2.4 billion. Our assessment is that the above increases are the minimum necessary if we are to come close to achieving the £3 billion target for the full financial year. The package is most unlikely to lead to higher Building Society rates.

We should be grateful for the Prime Minister's agreement to the proposed rates, if possible by tomorrow so that an announcement can be made then.

Yours ever,
Andrew Ellis

A M ELLIS
Private Secretary

23 JAN 198[illegible]



CHEQUERS
BUTLER'S CROSS · AYLESBURY
BUCKS

cc: MA
AT

Personal 30 Dec 1984

Dear Ralph.

Your 'Open Letter to the P.M'

was superb. We must repeat its

message over & over again. At

present the "spenders on more

investment" are becoming fashionable.

First - they don't consider the industries

that are lost by putting money

into the public sector

Second - much investment is capital

intensive not labour intensive.

Third - it would be better to reduce tax

because we *believe* that is best

and because cost is *too* high.

I noted all the names

that generously signed the letter.

We must have a get-together

so that I can draft a speech

welcoming your points & taking them

further.

Happy new year

Yours ever

Margaret

Rt Hon Margaret Thatcher

R21

With the compliments of

LORD HARRIS of High Cross

Dear Prime Minister, 19th December '84

My co-signatories asked me to send you the first copy. Alas the Times threatens to jump the gun.

Of course, we are trying to help against common foes.

Best possible wishes for 1985, etc,

Ralph Harris

TWO LORD NORTH STREET WESTMINSTER SW1P 3LB
Telephone 01-799 3745

Prime Minister 4

JV 21/12

Open Letter to the Prime Minister

With the New Year approaching, we send you our best wishes for the completion of the task that has been so bravely begun.

After decades of progressive enfeeblement which made us famous for the 'British Disease', the past five years have seen a transformation in the climate of economic opinion. It is now recognised that our 'full' employment was actually over-manning concealed by monetary debasement. The new realism which has brought inflation down from above 20% to 5% was bound to expose the extent of under-employed labour in the official statistics of the unemployed.

Unlike your critics, we acknowledge that the total of around 3 million ignores the turnover of about 500,000 people changing jobs every month and includes an unknown but large number working in the black economy. Nevertheless, involuntary unemployment inflicts avoidable suffering on many people and represents a loss of potentially productive resources. Accordingly, we believe our most urgent concern must now be with the obstacles that prevent so many unemployed people from finding employment.

When you and the Chancellor tell critics there is no easy lever to pull, we understand that you are rejecting the old myth that lasting jobs can be created simply by pumping still more public spending into the economy. We agree that would only lead to accelerating inflation and higher interest rates - both of which have damaging effects upon jobs. But we believe there are obstacles to employment which you have inherited from past governments and which should now be removed without fear of rekindling inflation.

(1) A major reason for our high level of unemployment is, simply, that unit labour costs in Britain have run ahead of productivity. In America, 38 million new jobs have been created in the past 20 years by holding the rise in real wages to 8%, whereas in Britain real wages have increased by 48% and we have lost 2 million jobs. Nearer to home, between 1976 and 1982, our labour costs per unit of output rose six times faster than in West Germany. No wonder America and West Germany have significantly lower unemployment rates. Yet the Chancellor's recent economic statement warns that UK unit labour costs are expected to continue to grow faster than our major competitors. If that is so, we might expect unemployment to rise still higher.

There are a number of reasons why the cost of labour in Britain continues to rise in spite of high unemployment. The first is the activities of trade unions which restrict efficiency and push wages above the market clearing rate. Short-sighted trade unionism is thus clearly a major cause of unemployment, particularly when national bargaining sets wages without adjustment for differing market conditions (and costs of living) in different parts of the country. Furthermore, in their insistence that jobs should be preserved whether or not an industry is profitable or there is a demand for its product (witness the miners' strike), they raise costs and taxes and so hinder the creation of new jobs in the industries and firms of the future. How would Lancashire cotton have encircled the world in the last century if some rustic Arthur Scargill had been able to preserve the handloom weavers in perpetuity?

We applaud the 1980, 1982, and 1984 Employment Acts, but consider that this legislation should be strengthened in two respects. Firstly, since unions derive most of their power in wage negotiations and strikes from the closed shop, we believe this monopoly device should be outlawed. And, secondly, to enable employers to estimate wage costs with some degree of confidence, we now urge that unions be subject, like all responsible bodies, to civil proceedings for damages caused by breach of contracts.

2/...

High labour costs and unresponsive relative wages are also caused by Britain's 26 wage councils which set minimum wages and conditions of work for two and three quarter million workers. They operate to reduce jobs for less productive workers, particularly young people. It is said that the International Labour Organisation's Convention 26 binds us to maintain machinery to enforce minimum rates of pay where "wages are exceptionally low", and so rules out their abolition. We disagree, since social security benefits in effect set a minimum floor to wages in the UK. The wage councils should be scrapped immediately.

High labour costs comprise more than wages. A whole spate of legislation such as Employment Protection, Health and Safety at Work, Equal Pay, etc., all impose obligations and costs on employers and need to be drastically pruned. Moreover, employers' national insurance contributions (nics) levied at 10.45% on wages between £1,768 and £13,000 per annum are a considerable additional cost. The Economist pointed out recently that if the minimum at which nics are paid were raised to £6,000, it would become 10% cheaper to employ the 40% of British workers with wages below that level. Since unemployment is concentrated amongst such workers, this reform would price many back into jobs.

Unemployment is determined not only by labour costs, but also by the monetary advantage of working compared with not working. Our tax-benefit system now decrees that for many people in low-paid jobs there is no advantage in taking a job. An unemployed person receiving various state benefits who manages to get work at £40 or more a week, automatically forfeits all benefits and pays national insurance at 9% and income tax at 30% on all earnings over £39 per week. A single householder living in local authority accommodation would need to earn at least £94 per week to be a mere 10% better off by working, whilst a man with four children would need to earn £189 to be £20 better off. So it is no wonder that many people deliberately opt for unemployment.

The Chancellor announced in his Autumn statement that he might have £1.5 billion for tax cuts in his next budget. We strongly support much higher tax cuts financed by radical reform of welfare on a more selective basis. All such savings should be concentrated on raising tax thresholds and perhaps re-introducing the lower-rate tax bands. An urgent priority is to eradicate this poverty trap and improve the rewards for working.

Finally, Prime Minister, it remains true that while parts of the country have very high unemployment, others have relatively little and, indeed, meet difficulties in recruiting some types of labour. In order to narrow such difference, workers must be prepared to move as in America, which now has much lower unemployment. The main explanation of Britain's low level of labour mobility is the large amount of council housing on the one hand, and the steep decline in privately-rented accommodation on the other. A study in Scotland, for instance, concluded that 25% of all moves to take up new jobs were frustrated because it would have meant leaving a council house with no guarantee of immediately getting another nearer to work, and with no privately-rented housing to provide temporary accommodation. The lesson is clear: in order to improve labour mobility the Government must speed up sales of council housing, reduce the 5-year qualifying period on re-sale, and take steps to revive the rented sector by freeing all new lets from rent control.

There is nothing inevitable about high levels of unemployment. If wage rates were sufficiently flexible, if there was a real reward for working at lower levels of earnings, and if labour were more mobile, the unemployed would be chiefly confined to people temporarily between jobs, those undergoing training or retraining, and those incapable of working.

We are confident you will maintain and even intensify pressures for cost reduction through efficiency, not least by further denationalisation, deregulation, and competitive contracting. If the results of your first five years are to bear full fruit in extending employment at realistic labour costs, we believe 1985 should see urgent action along all of these lines. The requirement is nothing less than the reversal of well-intentioned policies of past protectionism that have now become the chief impediment to more widely shared prosperity.

Lords Coleraine
Harris of High Cross
McFadzean of Kelvinside
Montgomery of Alamein
Orr-Ewing
Rugby

Michael Brown, MP
Christopher Chope, MP
Michael Fallon, MP
Michael Forsyth, MP
Neil Hamilton, MP
Alan Howarth, MP
Gerald Howarth, MP
Robert Jones, MP

D.I. Allport
Ronald Halstead

Professors Brian Griffiths
Patrick Minford
Alan Peacock

19 December 1984

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

10 August 1984

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

D Nigel,

CAPACITY CONSTRAINTS IN MANUFACTURING INDUSTRY

Thank you for your letter of 19 July with which you enclosed the useful Treasury paper on this subject which I have read with interest.

2 The paper's conclusion that manufacturing output could rise by perhaps a further 10% before capacity utilisation reached the levels associated with pre-1979 peaks is most welcome. However, I am very conscious that at a disaggregated level there is considerable variation in the degree of capacity utilisation between different industries. Moreover, although I agree that the availability of plant capacity is more likely to limit the present recovery than the usual shortages of skilled labour, there are undoubtedly industries where this may not be the case; you refer in your letter to the computer industry for example.

3 You will also be aware that one of industry's major concerns at the moment is the shortage of qualified engineers. The general consensus of last month's Cambridge Manufacturing Forum, which was addressed by Kenneth Baker, was that a major obstacle to the rapid uptake of new manufacturing systems was a shortage of well qualified manufacturing engineers to conduct the strategic planning and implementation of new systems.

4 Perhaps our officials should keep in touch on this subject. I am copying this letter to the Prime Minister, and to Tom King.

Norman

NORMAN TEBBIT

JH2AWV

Econ Pol Strategy Pt 2

13 AUG 1984

3

PRIME MINISTER 26 July 1984

FUNDING MEETING, 24 JULY 1984

The Funding Meeting was like a wake following the death of low interest rates.

National Savings now expect brisker sales, as they have raised their interest rates to 12.75 per cent on Income and Deposit Bonds, and 9 per cent on their Certificates - a 1.75 per cent increase.

The Bank is recommending carrying on with its sales policy of tranchettes of a full range of instruments (shorts, mediums, longs and index-linked securities). If market conditions strengthen, the Bank would propose a new partly-paid short, and they are also contemplating putting to the Financial Secretary some proposals for call options and zero-coupon bonds. These would need careful appraisal before agreeing to them.

I argued at the meeting that the market was now worried about 3 issues:

1. Does the Government have a sterling target? Is it going to increase interest rates again if the pound falls further?

E.R.

2. Money growth has been excessive in the first 3 months of the year.

3. Is public expenditure under control?

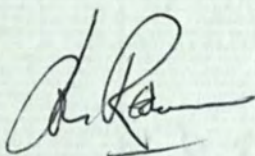
I suggested that the only way to reassure the market is to demonstrate by actions that these problems are of the market's imagining; that the Government does not have a sterling target and is not intervening; that the monetary problem will be corrected as the heavily front-end loaded PSBR comes under control; and public expenditure will remain disciplined as the announcement on local authority spending this week should have reaffirmed in part. The most important thing is to persuade market participants that the next move in interest rates is going to be down. The Bank of England still has considerable influence in money markets and, through its actions, will have to persuade the market that this is both likely and possible.

Some people at the meeting were sceptical about whether it was now possible to create this virtuous circle, decoupling sterling rates again from US rates. The meeting was unsure about whether US rates would go up further or not, was naturally concerned about the industrial background, and felt that US and UK rates would remain closer together for rather longer than we wanted. Some felt there might be another increase in both US and UK rates.

E.R.

The Bank did not recommend a new full-scale long stock: this idea is currently out of favour with most at the meeting, and Eddie George, who most favours it, was absent.

The one piece of good news is that equity sales by the public sector are running at a satisfactory level, and companies are still raising substantial sums of money from the equity market (eg recent Nat West and Thorn rights issues).



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SSL Cile

10 DOWNING STREET

From the Private Secretary 20 July 1984

National Savings

The Prime Minister has seen and accepted the Chancellor's proposals for the revision of the terms of National Savings instruments.

A Turnbull

David Peretz Esq
HM Treasury

CONFIDENTIAL

8.18

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

19 July 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry

Dear Norman

CAPACITY CONSTRAINTS IN MANUFACTURING INDUSTRY

I recently asked my officials to take a look at the evidence for both actual and prospective capacity limitations in manufacturing. I thought you might like to see the enclosed paper which reports their analysis. I understand that your officials have seen it in draft and are broadly content.

In the absence of direct measures of capacity utilisation, the analysis necessarily places a great deal of weight upon the results of the CBI survey. This provides indirect evidence in the form of the percentage of firms reporting that they are working below capacity.

The paper suggests capacity utilisation is now back to the average levels seen in the 1960s and 1970s, leaving scope for further growth in manufacturing output. It also suggests that the higher levels of investment now evident and in prospect will increase the headroom available.

An analysis of the figures by industry suggests little sign of overheating. With the obvious exception of the computer industry, the firms which are operating close to capacity tend to be in the consumer sector. These industries do not seem to be investing particularly heavily at the moment, again suggesting that capital shortages are not yet critical.

In contrast to the experience of previous recoveries, there is little evidence of skilled labour shortages at the moment. Although shortages of technical staff do appear to have emerged in certain sectors of industry, this does not seem to be critical, except perhaps in the computer industry.

I am sending copies of this letter and paper to the Prime Minister and to the Secretary of State for Employment.

Yours
Nigel

NIGEL LAWSON

TH EVIDENCE FOR CAPACITY LIMITATIONS IN MANUFACTURING INDUSTRY

1. Introduction

1. In contrast to the experience of previous upturns when shortages of skilled labour have constrained manufacturing output, the evidence from recent CBI surveys suggests that deficiencies of usable plant capacity are currently more likely to be relevant, at least at the aggregate level. This note examines the available evidence and attempts to assess the implications for the current recovery.

2. Indicators of productive capacity in manufacturing

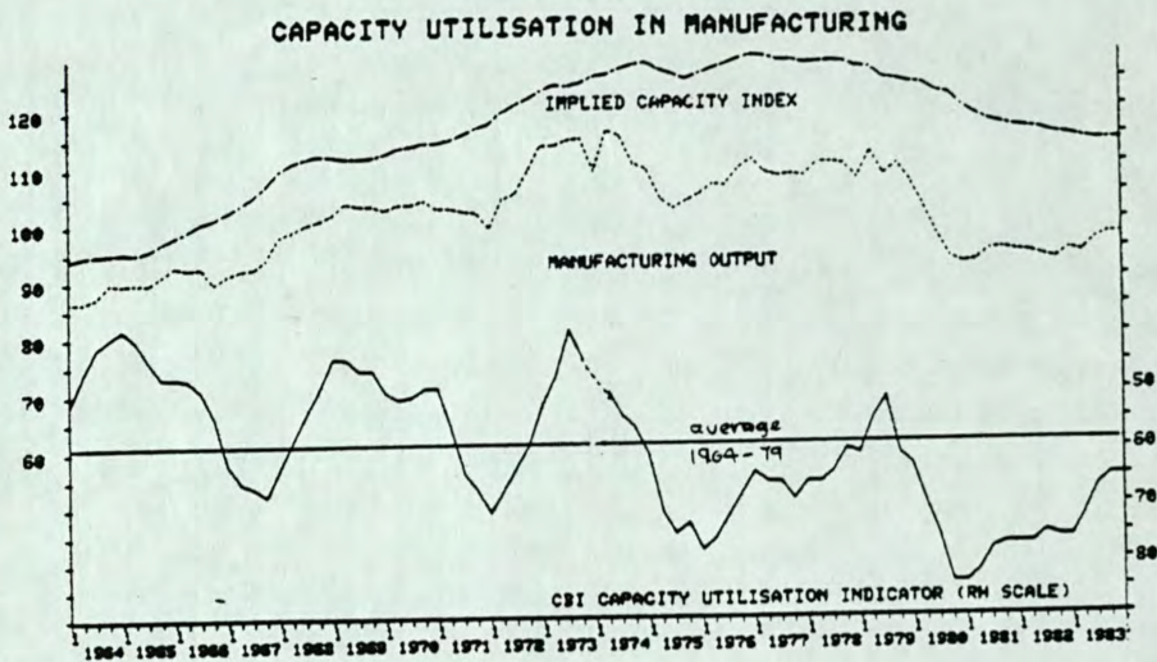
2. The idea that plant capacity constrains output has a strong intuitive appeal. However it is in practice very difficult to define productive capacity in a precise way. It would clearly be wrong to view plant capacity as an absolute constraint on production since it is almost always possible to increase the output of a given plant or machine by increasing manning levels or by simply operating it longer through overtime or extra shifts. The limits to this kind of increase are economic rather than physical. For this reason capacity must be viewed as an economic as well as a physical concept, depending upon prices, wages and profitability as well as technology.

3. The distinction between economic and physical capacity has become crucially important in recent years as increases in relative energy costs have made large sections of the capital stock economically obsolete, even though they have remained physically capable of production. This has made it very difficult to judge the extent of spare capacity in industry. It has effectively ruled out the use of conventional physical measures of the capital stock in studies of productive potential.

4. One way of overcoming this problem is to rely on the judgement of managers as to what the full capacity level of output actually is. This is essentially what the CBI survey does when it asks firms whether they are operating below capacity. The results of this survey - the percentage of firms saying that they are operating below a "satisfactory full rate of operation" - are shown in the lower panel of Chart 1 below. In order to show an increase in the

level of capacity utilisation an an increase in this measure, the left hand scale has been inverted. There is of course no certainty that the levels indicated by this response will not move over time as answering practices change, but we would expect movements over shorter periods and hence the cyclical pattern to remain unaffected by such a drift. In practice the CBI series fits in very well with other evidence and indicators of pressure in manufacturing industry.

CHART 1



5. The chart sets the CBI measure of utilisation alongside the CSO's manufacturing output index. The peaks in the former lead naturally to the idea of 'peak capacity utilisation' - the level of utilisation typically associated with peaks in output. However we should not necessarily view this an indicating the maximum level of capacity utilisation which the economy could economically or physically achieve. This would only be appropriate if capacity has consistently acted as an effective constraint on output in recovery periods and there is little direct evidence to suggest that this is the case. On the other hand, the peak levels of utilisation indicated in the

chart were only attained for brief periods and may not represent levels which are sustainable in the longer run. For example, it has been suggested that the 1973 peak was not sustainable.

6. Rough and ready indicators of the level of useful manufacturing capacity can be constructed by suitably combining the CSO output and CBI utilisation indices. An example of such an "implied capacity index" is shown in the upper panel of Chart 1. The scale used to represent this index is inevitably highly arbitrary. It was calibrated with reference to the 1964 peak in utilisation, so that at this point it equals the observed level of output plus an arbitary five per cent. Although it cannot indicate "full capacity", this measure does at least give a rough indication of the level of manufacturing output which might be achieved if plant capacity utilisation were to significantly exceed previous peaks. We would regard this very much as an upper limit.

7. This index can also be used to compare the implied level of capacity at different points in time. For example it suggests that there was very little increase in potential between 1974 and 1979, and that there has been a large fall since then. This is despite the high levels of investment which were maintained during the 1970's, and almost certainly reflects the effect of adverse movements in energy prices and other developments on economic capacity.

3. The factors limiting manufacturing output in previous recoveries

8. This section takes a brief look at the constraints which were operative at previous output peaks, and ask whether output was limited by deficient capacity or by other factors. The most obvious of these are shortages of skilled labour and the availability of finance.

9. These factors work rather differently from capacity constraints. In the case of labour we would note three important differences:

(a) Labour is much more mobile between firms than is capital, so that an individual firm can usually attempt to side-step labour shortages by bidding higher wages for the workforce it needs. This type of constraint is therefore felt in the market for a specific type of skill, usually in a particular location or industry, although it may spill over into an economy - wide skilled labour shortage. Such constraints will tend to be reflected in wage pressures with all their associated macroeconomic

effects. This is the most immediate threat which labour shortages post to a recovery.

(b) Although capital tends to be immobile and specific to particular firms or technologies in the short run, it is quite flexible in the longer run. Capacity limits can be pushed back by investment in new capital assets and in this sense are a dynamic rather than an absolute constraint on output. Providing that adequate levels of investment and profitability are maintained, there is no reason why plant capacity, output and demand should not expand continuously and in parallel. It is more difficult to increase effective labour capacity or to adjust to specific shortages through resettlement, retraining and the like.

(c) Reflecting (b), sustained economic growth requires a flexible supply of capital goods. In a closed economy this could put severe strains on the capital goods supply industry, frustrating the general recovery. However in an open economy such pressure points can in many instances (particularly in the case of plant, machinery and vehicles) be relieved by imports, unless of course there is a world wide shortage of capital goods. Labour shortages are again more critical in this respect.

10. Financial constraints may act in several different ways. To the extent that firms rely on internal rather than external finance they will be firm-specific, and the growth rate will be related directly to the rate of profitability and cash flow. But to the extent that firms finance their expansion externally this will put pressure on the financial markets and interest rates and this will have macroeconomic effects which impede recovery.

11. How have these various factors served to constrain previous recoveries in manufacturing? The CBI survey again offers interesting evidence on this, in the response to a direct question on the factors

limiting output. The percentage of firms citing skilled or other labour shortages on the one hand and plant capacity or materials shortages on the other are shown in Chart II. The percentage of firms citing delivery dates as an important limiting factor on export orders is shown in Chart III.

CHART II

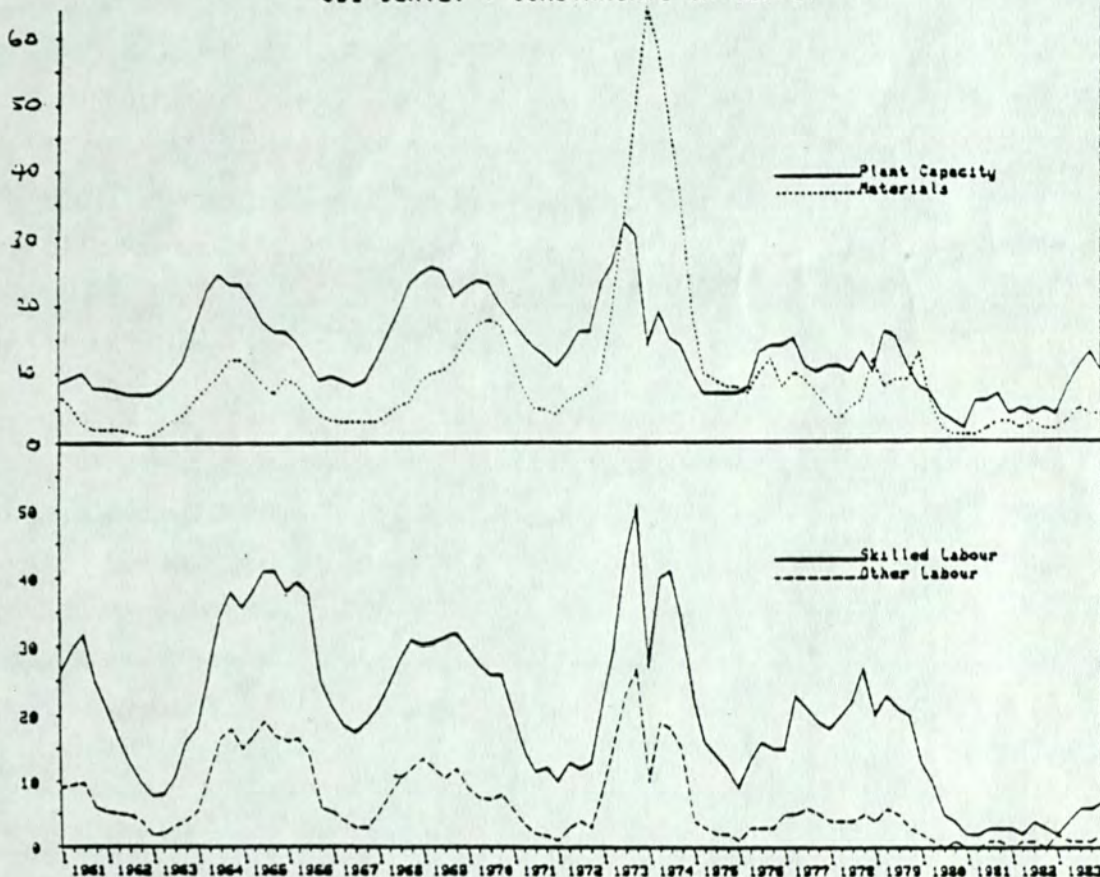
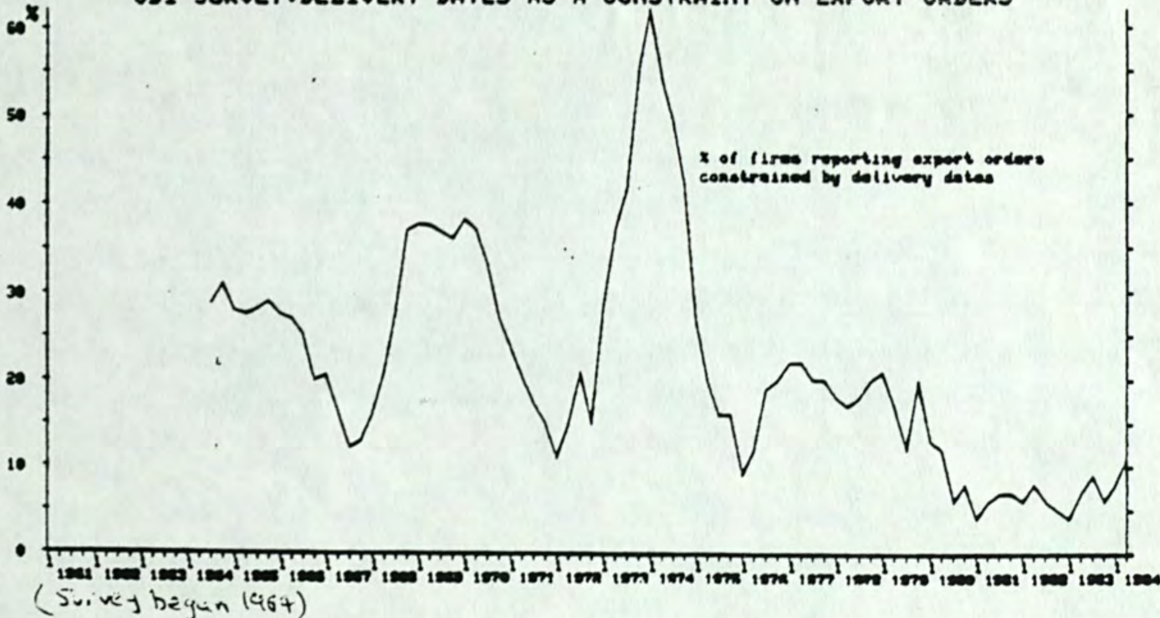


CHART III



(Survey began 1964)

12. Although these constraints have varied in their effecti●ness with output levels, so that their effects are difficult to distinguish, the chart suggests that skilled labour shortages were probably more effective in limiting output than capacity until 1980. Taking the period 1961-79, the percentage of firms citing the former averaged 24% (ranging between 8% in early 1963 to 51% in late 1973) as against 14% for the latter (ranging between 8% and 32%). There also seems to have been a general shortage of labour at times, particularly during 1964-66 and 1973-74. These labour shortages were clearly reflected in wage pressures, which through their macroeconomic effects have arguably played the crucial role in arresting the last few economic recoveries. However it is important to note the effect which the general overheating of the economy had on the balance of payments during the 1960s and the stop-go cycle which this involved. Capacity shortages were clearly very relevant during these years.

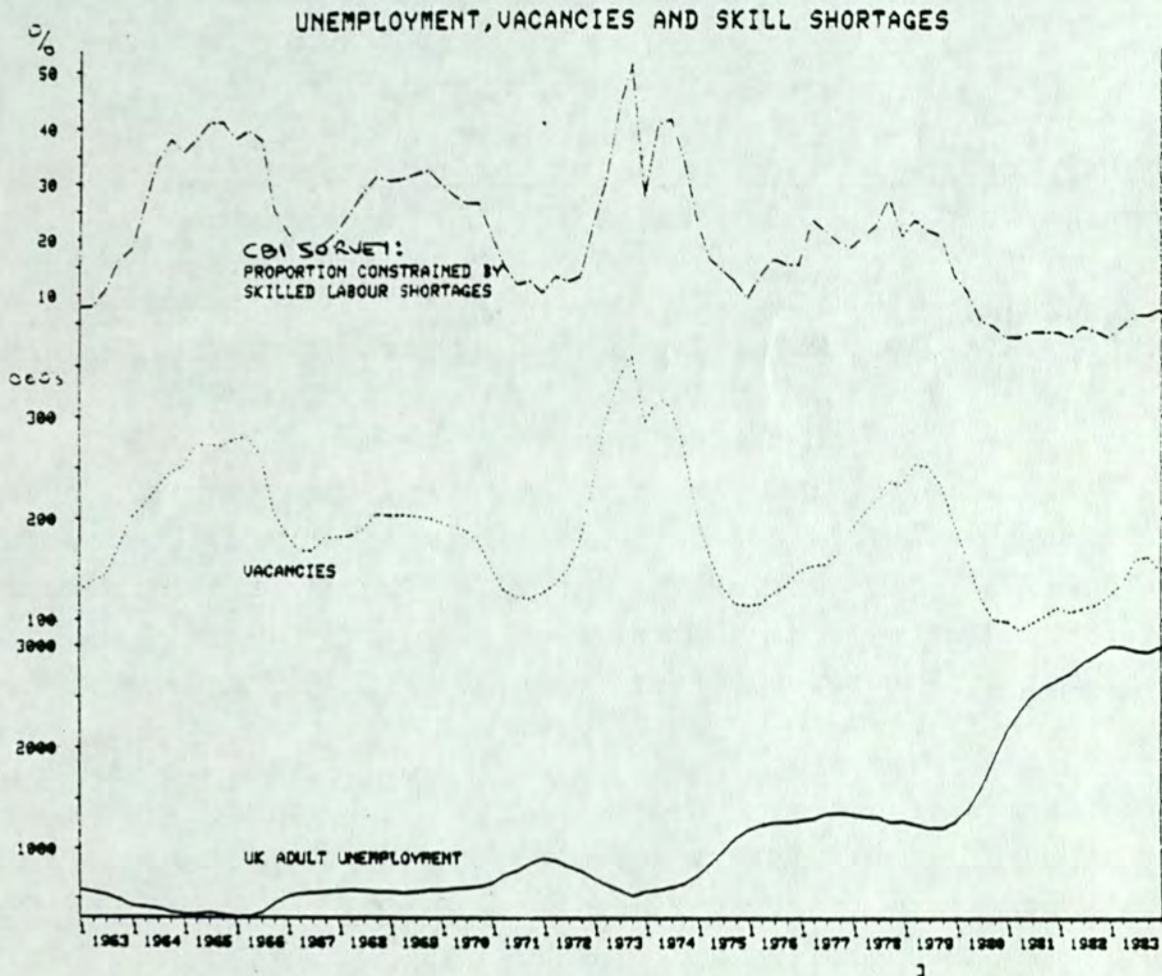
13. Although CBI evidence on financial constraints is very patchy due to changes in the questions posed, this does reveal that some firms were constrained by the availability of external finanace during 1966-67 and again during 1970. There was also a marked increase in the number of firms citing a lack of internal finance as a reason for not investing during the liquidity squeeze of 1974-75 and again during 1980. The cost of finance was also significant during 1980 and again in early 1982.

4. Current evidence on capacity utilisation in manufacturing

14. In contrast to the experience of the past 25 years, Chart II makes it clear that labour shortages in manufacturing are not generally regarded as being important at the moment. By mid 1982 only 2 per cent of CBI respondents were reporting skilled labour shortages. This figure has now increased to 7 per cent but is still well below the pre-1979 average. Chart IV shows that the CBI labour shortage and official vacancies series are closely correlated. The vacancies and unemployment series both support the view that there is a great deal of slack in the labour market at the moment. On the other hand, turning back to Chart II, the proportion of firms constrained by plant capacity has risen from 4% in mid 1982 back to its historical average of 14% in recent months.

15. Chart III shows that although poor delivery dates have remained a constraint on the exports of some firms during the recession and increasingly so over the last year as export growth has resumed, this factor is not as important as it was before 1979.

CHART IV



16. What seems to have happened is that the specific nature of capital assets - particularly those in energy and labour intensive activities - has led many of them to become economically obsolete in the face of changes in relative prices. At the same time these changes have also made the associated labour skills redundant as is clear from the pattern of unemployment. However the reduction in the effective capital stock appears to have been greater than the reduction in the effective labour supply, making capacity the more relevant constraint on output. The fall in potential is clearly reflected in the implied capacity index shown in Chart I.

17. Nevertheless this chart suggests that the capacity constraint still allows some headroom for manufacturing output growth, reflecting the fact that utilisation has only reattained average rather than 'peak' levels and that it might be pushed beyond these levels without serious problems emerging. It suggests that output could perhaps rise by a further 10% before utilisation would reach the levels associated with previous peaks. However it would not take very much of an increase to push utilisation back to the level seen at the relatively low 1979 peak.

5. The prospects for future increases in manufacturing capacity

18. Since as we have seen capacity acts only as a dynamic constraint on output it is important to consider prospective changes in capacity over the next few years. If further adverse movements in relative prices take place this will make the capacity constraint that much more serious. But on the other hand the recent and increasingly well established revival in manufacturing investment will have the effect of pushing up capacity, leaving more headroom for output growth. Since the pace of the current recovery in manufacturing is quite modest by recent historical standards it could be some considerable time before capacity is being fully employed.

19. A major reason for the revival in investment plans can be found in the marked recovery in profitability which has been evident recently This appears to be fairly widespread across manufacturing, with the average real rate of return on capital rising from just 3½% in 1981 to 6% in 1983 and increasing further this year. This will have had the effect of making investment out of internal cash flows easier and certainly more profitable. Reflecting this, the number of CBI respondents citing a shortage of internal finance as a constraint on investment fell to 19% in April, the lowest figure seen since this question was first asked, late in 1979.

20. The financial outlook seems generally favourable to investment at the moment, particularly in view of the short-term incentive effect of the budget. The experience of previous output cycles perhaps suggests that the demands made by industry on the financial markets, to finance development expenditures which they cannot meet out of internal sources, might push up interest rates to levels which threatened the recovery. However this problem is not an immediate one, and would again take time to develop given the pace of the current recovery in company expenditures. In the June forecast, which took account of these presures, we saw real interest rates remaining

high, but there was little in the domestic prospect to point to higher rates.

6. Capacity constraints at the industrial level

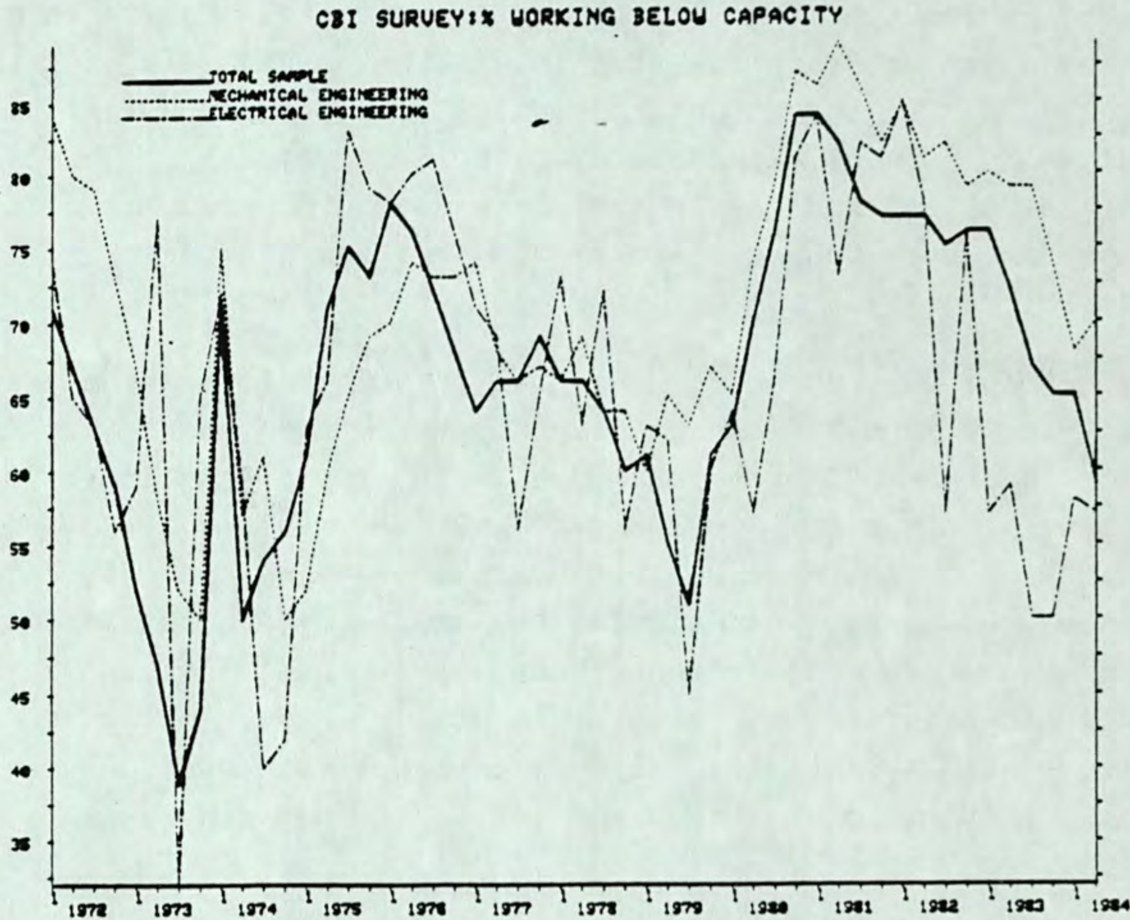
21. The recovery in investment plans may also be a response to capacity constraints, both actual and prospective. However there is not much support for this view in a detailed analysis of the recent CBI and DTI investment surveys. These suggest a widespread revival in investment expenditure, both in industries in which output and utilisation levels are high and rising (such as chemicals) and those in which these levels are low and tending to fall (as in the motor industry).

22. One possible reason for the poor relationship between current capacity levels and investment plans is that firms are investing in order to increase efficiency as much as to expand capacity. This is consistent with the April CBI Survey which suggests that 78% of firms are investing for the first of these reasons and only 20% for the second. If this trend continues then the higher level of investment now projected may not make very much of an impact upon physical capacity levels. However it will make for increased economic viability. And as utilisation improves we would expect a greater proportion of investment to be directed towards increasing capacity.

23. The industrial detail is nevertheless interesting since it suggests that the capital goods industries are not as yet working under much pressure. The April CBI survey shows for instance that 70% of firms in the mechanical engineering industries are currently working below capacity as against 57% in electical engineering and 59% for the whole of manufacturing. The response of these sectors to this question in previous surveys is shown in chart V. Further analysis shows that just under 50% of firms in the electronic and electrical capital goods and instrument engineering industries are reported to be below capacity, but this largely reflects the fact that the technological or energy-saving characteristics of these industries has sheltered them from the worst effects of the recession. Of the industries with less than a third of firms below a satisfactory level of output, most - footwear (19%), other leather goods (30%), wool textiles (30%) hosiery and knitwear (29%) and furniture (29%) - are in the consumer goods sector. These are also areas in which a lot of capacity has been shed in recent years. The only other sectors

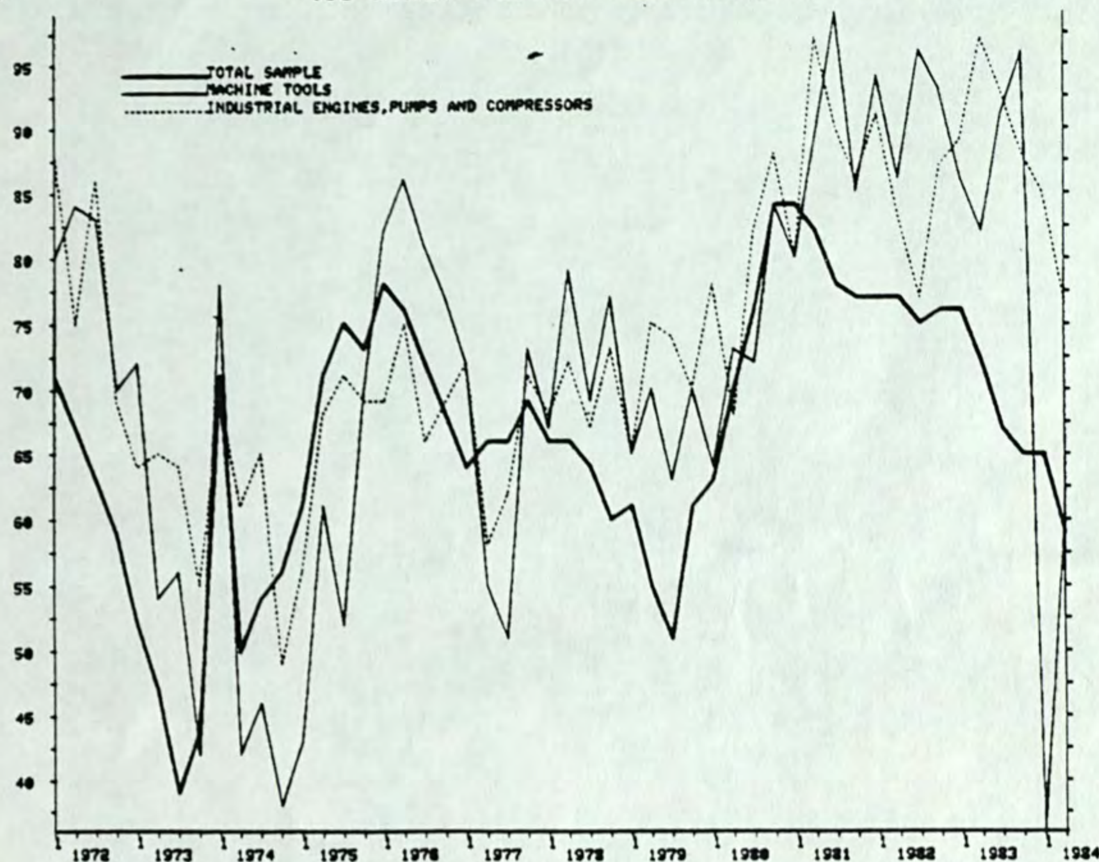
working so close to capacity are office machinery and data processing equipment (30%) and industrial chemicals (31%).

CHART V



24. The only capital goods industry which has come under any pressure in recent months is machine tools - again an area where a lot of capacity has been shed. The January CBI survey revealed a marked improvement in orders for machine tools. This was reflected in the response to other questions, particularly the percentage of firms reporting that they were below capacity, which fell from 98 to 36%. This moved back up to the average for manufacturing in May. Chart VI shows the CBI results for capacity in machine tools and the industrial engines sector. These tend to move in a similar way, lagging slightly behind the total manufacturing sample.

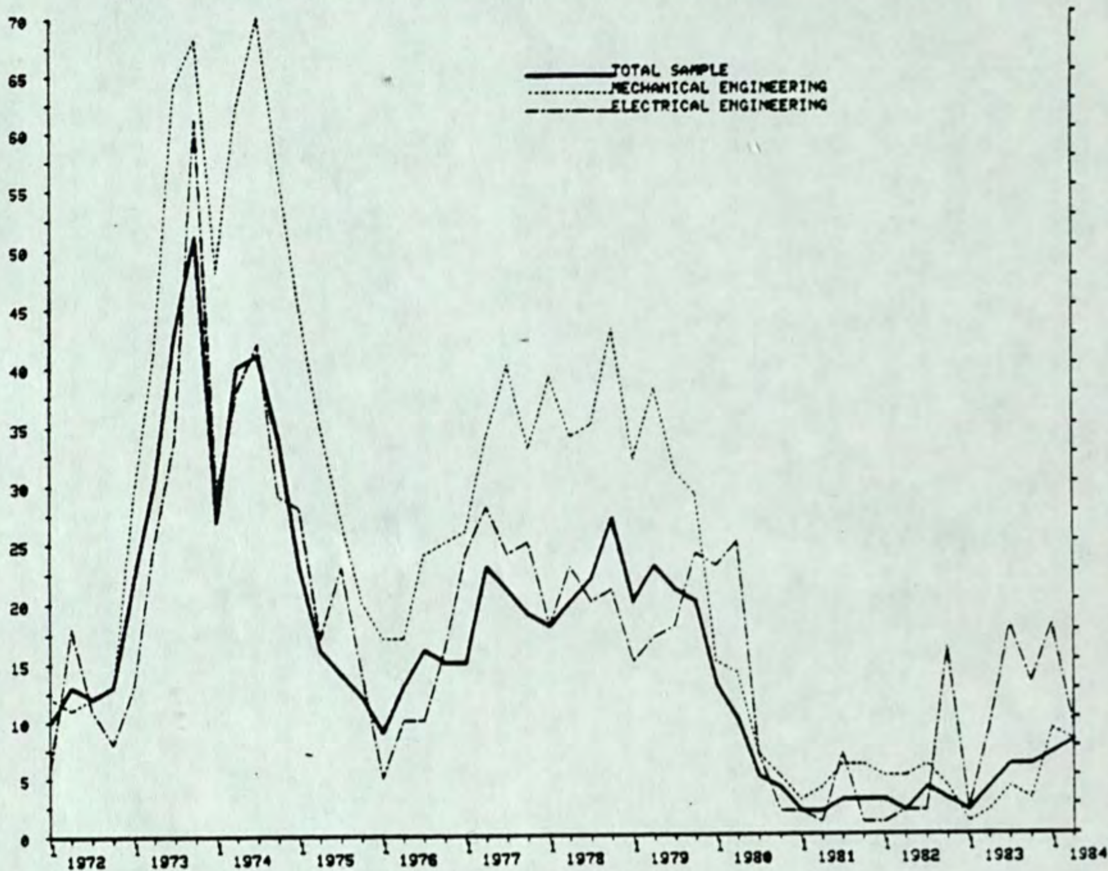
CHART VI



7. Labour market indicators

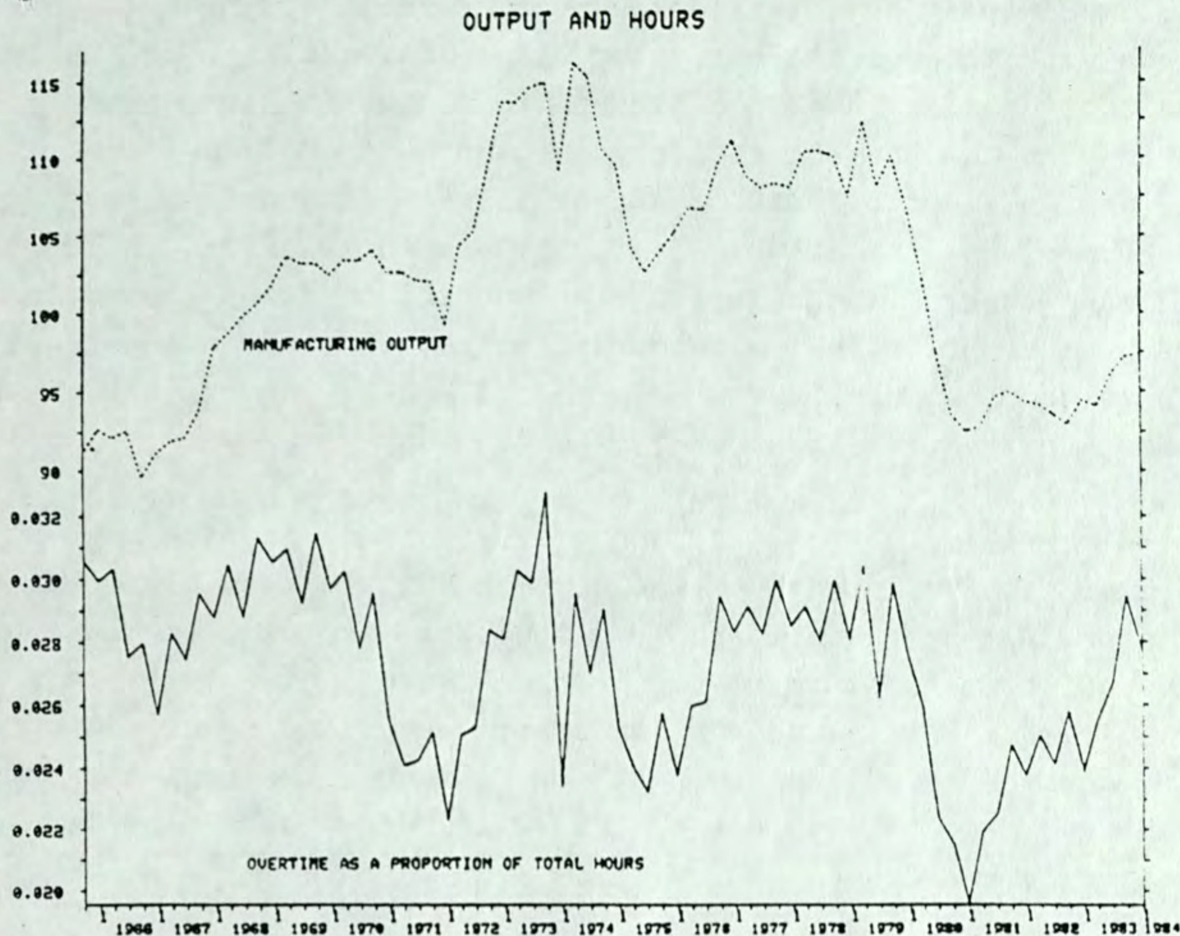
25. The disaggregated information from the CBI surveys suggest that most sectors of manufacturing have experienced only small increases in skilled labour shortages over the past two years. The results for mechanical and electrical engineering are shown in Chart VII. Emerging constraints have been most evident in the electrical engineering and textiles industries where about 20 per cent of firms were reporting shortages in early 1984. Within the former sector, shortages of skilled labour appear to be quite acute in certain areas such as computers. There is no evidence of any skilled labour shortage in the mechanical sector.

CHART VII



26. Consistent with the apparent absence of significant labour shortages there is little evidence of upward pressure on wage settlements, though the downward movement of recent years seems to have been arrested. Only the overtime data seem, at first sight, to be providing a contrary indication. Chart VIII shows that, since early 1981, the proportion of overtime hours to total hours worked in manufacturing has risen from a deep trough to a level close to the 1979 peak.

CHART VIII



27. A similar rapid rise in overtime during 1972 and 1973 was clearly associated with widespread labour shortages. But it seems more likely that the recent rise simply indicates a cautious response by firms to the very modest upturn in output. Having been caught with too much labour in 1980 and undergone the painful process of labour shedding, firms are now reluctant to take on more labour until they feel confident that the recovery will be sustained. There may at this stage be some reluctance by firms to take on unemployed labour of unknown quality while their existing workers are prepared to work more overtime. But as recovery continues, it seems likely that future increases in the demand for labour will be met more by rising employment than further increase in overtime. There would certainly appear to be enough slack in the labour market to permit this.

7. Conclusion

28. In contrast to the experience of previous upturns, the evidence suggests that the availability of plant capacity is more likely than shortages of labour or finance to be the factor identified as limiting the present recovery in manufacturing. However utilisation is still only at average levels and does not as yet pose a serious limitation. To the extent that individual pressure points do emerge, these are likely to spill over into imports. More general pressures, with direct effects on prices and indirect effects working through the effect of a higher import bill on the exchange rate, seem less likely.

29. Given the high rate of productivity growth and the revival of manufacturing investment the current relaxed pace might be sustained for some considerable time before capacity begins to act as an effective constraint. This conclusion must however be a tentative one in view of our imperfect understanding of the structural changes which have been taking place in manufacturing industry in recent years and the effect of these and future developments on capacity trends.

8.25

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

Prime Minister (1)
The Chancellor considered a slightly more aggressive set of rates but decided against them in order not to give the building societies a pretext for going still higher – many are already set mortgage rates over 12½ per cent.
Agree Chancellor's proposals?
AT 19/7

Yes mt

19 July 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

NATIONAL SAVINGS

As Adrian Ellis's letter of 18 June outlined, National Savings results so far are well below the trend necessary to hit the funding target of £3 billion for 1984-85. But we judged it prudent not to take the initiative in improving the terms on National Savings until the building societies had moved their rates.

The Chancellor has decided that we ought now to move. The building societies announced last Friday an increase of 1½ per cent in their ordinary share rate, along with the increase in the "advised" mortgage rate to 12½ per cent. Since then, it has become clear that the societies' premium rates are likely to rise by rather more than 1½ per cent net. In setting the new National Savings rates, we need to take account both of the higher building society rates and also of the 3 percentage point increase in the banks' deposit rates, coming on top of the ½ per cent increase at the beginning of May.

The new rates would start to come into effect over the next week or so, and the proposed increases are broadly in line with those already made by the banks and the building societies. The rates the Chancellor has in mind are:

	%
National Savings Certificate	9.0
Income and Deposit Bonds	12.75
INVAC	12.0

In order to make clear that the recent rise in market rates will, we hope, be short lived, it will be stressed that the current certificate is being suspended and that the new certificate is temporary and may be taken off without notice. The Chancellor does not believe that the move will be seen by the building societies as unduly aggressive.

Subject to the Prime Minister's views, the Chancellor's intention is that the new terms should be announced tomorrow (Friday).

Yours ever
David

D L C PERETZ
Principal Private Secretary

CONFIDENTIAL

cc NO
File

FROM: L WATTS
13 July 1984

1. MR LANKESTER ✓ I endorse these proposals - see my note at the end. PL

2. ECONOMIC SECRETARY

cc PPS/Chancellor
Sir P Middleton
Mr Cassell
Mr Sedgwick
Mr M Hall
Mrs Lomax
Mr Culpin
Mr Standen
Mr Hood
Mr Ridley
Mr Gilbert) DNS
Mr Patterson)

NEW TERMS FOR NATIONAL SAVINGS

This submission seeks your agreement to new terms for most National Savings instruments, following today's announcement by the Building Societies Association.

Background

2. The advised mortgage rate is being increased from 10.25% to 12.5%. The advised ordinary share rate is being set at 7.75% (from 6.25%). Premium rates are likely to be adjusted similarly, to between 8¾% and 9¼%.

3. National Savings inflows (which were fair in April) have been disappointing in May and June, as have those for the building societies. The National Savings contribution to funding at end-June is put at £575 million, instead of £750m required to stay on course for the target of £3 billion. The forecasts for National Savings pointed to a worsening trend on unchanged competitiveness with building societies; National Savings might take perhaps £1 billion by end-September, two-thirds of the amount required to be on course for the target then, despite the package of minor measures announced in Mid-June to which there has been a mildly promising response.

4. In 1984-85 the PSBR is front-end loaded and so too should the National Savings contribution to funding it. But at the moment the National Savings contribution is well below even the required

uniform monthly inflow rate over the year. An improvement in competitiveness is obviously necessary. Table 1 attached gives a forecast of actual National Savings inflows over the next three months, that is, without adjusting for any seasonal influences which may be affecting inflows over the summer. It is very difficult to estimate pure seasonal effects on National Savings inflows, as this involves removing the effects of policy changes which may also tend to have a seasonal pattern. It is likely that seasonal inflows are low over the holiday season but we think that the effect of this is insufficient to affect our judgement that the National Savings products need to be made significantly more competitive to reach the £3 bn target. Furthermore the front end loading of the PSBR suggests that National Savings inflows should be high over the next few months, contrary to the normal seasonal pattern.

5. National Savings products are not all performing equally badly; indeed, the 27th Savings Certificate is doing moderately well. But the gross interest products (Invac, Income Bond and Deposit Bond), which will assume a new importance next year when composite rate tax is applied to the banks, are suffering. This probably reflects:-

(a) building society increased competitiveness on money at short, or no, notice for relatively large deposits;

(b) continutation of lost National Savings competitiveness from last summer when we increased our terms (except for the Savings Certificates) by significantly less than the building societies, and maintained that position this Spring when interest rates were last changed.

And in the more recent past, the banks have been fighting back in responding to building societies' competition by increasing their rates for 7 day deposit and premium rate money.

6. The building societies remain National Savings' principal competitor and in deciding on the movement in National Savings rates the advised rates announced today should be the main yardstick. As indicated earlier, maintaining the relative competitiveness of National Savings, as evidenced by recent results, would probably

mean National Savings falling a long way short of its funding target. We take the view that the increase in building society rates should therefore be more than matched. Another consideration is that the banks have increased their competitiveness vis-a-vis the societies; bank deposit rates have recently been increased by 3%, while those of the societies by only 2.1% (in grossed up terms). In our view this is another reason for exceeding the increase in rates announced by the societies. The question is how far above the building societies' increase should the National Savings increases be?

7. We see two main options:-

(a) to recover a significant element of lost competitiveness; broadly speaking, to increase all the main products by 0.5% net more than the building societies' move, rounding the gross products up to the nearest 0.25%: or

(b) a more modest adjustment shaving 0.25% off the rates in the more positive approach.

The resultant rates from both options are set out in Table 2. Under either option the 27th National Savings Certificate would be replaced.

8. The following arguments favour course (a):-

(i) greater certainty of inflow and target achievement; our calculations suggest that this package should certainly enable us to meet the target;

(ii) a bigger contribution as early as possible, helpful for PSBR purposes;

(iii) thus some easing of pressure on gilts, when the market sees National Savings taking it share of the funding burden.

9. Course (a) could be seen as rather aggressive, and may be interpreted by the market as a sign of high (13%) rates and anxiety. But against that, this is what is needed to get the funding and there is much else going on so that this may pass unnotived. Given current uncertainty we suggest there is little harm in exceeding

the £3bn target if that should occur. We may be glad of the extra receipts; and with the bias on the variable rate gross products we have scope to act quickly if necessary. Course (b) lessens the disadvantages but our calculations suggest that course (b) might leave us undershooting the target and leaves us open to the risk of having to increase National Saving rates again, which could be very difficult to do.

10. Our firm preference would be to opt for course (a).

11. As to the individual products, assuming you endorse course(a), the following would be the new terms:-

(i) National Savings Certificate: Once the new 28th Issue is announced with its higher yield, the current 27th Issue is virtually moribund. There will be no last minute surge of sales (as can occur when there is a prospect of an Issue being replaced by a lower coupon Certificate). The new Certificate, on either proposed rate, would offer the biggest coupon since 1982, and there will be a sizeable differential (1.75%-2.0%) over the 27th's yield. Some switching is inevitable, particularly from the 27th Issue with its sales of £300m; some 30% of which is maximum holding probably in the hands of higher rate taxpayers who will normally want to hold on. For the earlier issues, the rate of growth of interest should act to hold in savers who in many cases will have in sight annual yields of 9% or more which would be lost on switching. In the absence of an attractive certificate those who want to switch would go outside National Savings. The 27th Issue will be left on sale until just before the 28th is launched on Monday 6 August. The overall yield of the 28th Issue would be 9.25%, compared with the 7.25% over 5 years on the 27th Issue. We suggest a maximum holding of £5,000. The rake on the 28th Issue will follow the usual slope. New Common Extension Terms will also follow and the rate for CET will be fixed at 8.76%, about one-half per cent below the rate on the new Certificate.

(ii) Invac: The interest rate would rise from 9.25% to 12.25% . Invac funds are fairly liquid (money at one month's notice) but the large Invac stock of about £5 billion must be defended, and Invac has been faring very badly recently. The new rate would apply from 30 July.

(iii) Income Bond: The net monthly inflow has been halved since the rate was reduced on 3 May. The funds raised through the Bond represent good quality funding and the hope is to restore the Income Bond to the star performer it was prior to May. The present rate of 10% would be increased to 13.0%. Six weeks' notice of a change of rate is required with the new rate applying from 30 August.

(iv) Deposit Bond: The same rate as for the Income Bond will apply to this instrument, and the new rate effective on the same date. Inflows may be improved, without any extra staffing cost, if the minimum deposit/balance is reduced from £500 to £250. This would also set up the Bond to attract money diverted from the banks on the approach to the implementation of composite rate tax.

(v) Yearly Plan: The same relativity with the conventional National Savings Certificate originally set should be maintained. The new rate would then be 9.3%, effective from the date of announcing the package. DNS attach importance, in the light of the very recent launch of this instrument, to making the change immediate.

12. Premium Savings Bonds

It is now 4 years since the prize fund interest rate was last set and over 3 years since the number of monthly prizes and the odds were fixed. The opportunity should be taken to announce in the context of the proposed National Savings package an increase in the rate of interest in the prize fund (currently 7%). If you decide in favour of our recommendation, we suggest a new rate of 7.75%. Three months' notice is required for a change in the prize fund, so the changes would take effect from 1 November. The intention is only to announce the interest rate change in the package and to publish the details later after Ministers have seen them. DNS

will contain any manpower implications from this change from within the manpower limits fixed in PES 1984. Although the change should be good in terms of DNS image, it has to be recognised that we do not look to this particular proposal for a large contribution to funding.

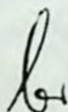
13. Timing

The National Savings response to the building societies' increases should be announced as soon as possible in order to avoid conjecture about the Government's reaction. The timetable requires your decision over the weekend and early clearance with No 10. If DNS can have Ministers' decisions no later than early on Tuesday 17 July, the timetable of changes suggested above will be met. (The same operational dates would apply in the case of the more modest package.) The aim is to have a public announcement of the package in the afternoon of Tuesday 17 July. I therefore attach a draft letter to No 10 advising the Prime Minister of the proposed package. The draft can serve whichever package you prefer.

14. Conclusion

We recommend that a new National Savings package be announced on 17 July. While we recognise the sensitivities attached to the more positive package, that is the one which we recommend. On our best figuring that package should certainly achieve the £3 billion target. The more modest package might achieve the target, but equally may undershoot by a small margin. In addition to the changed interest rates which we suggest, we should also be grateful for your agreement to make the change to the Premium Savings Bond interest rate, and to the minor change on the Deposit Bond minimum purchase.

15. This submission has been agreed with DNS.



L WATTS

National Savings rates clearly need to go up by more than building society rates if we are to get back on track to meeting the £3 billion target. The question is how much.

DNS have done an analysis of the past monthly performance of the various NS products, taking into account the differentials that have existed between NS and building society rates. Based on this analysis, and taking into account the point that there may be some seasonality in NS flows, there is a reasonable prospect that with the less aggressive package (ie 7(b) above) we would meet the £3 billion target. Nonetheless, I would still recommend the more aggressive package (ie 7(a)) for the following reasons:

(i) bank 7-day deposit rates have gone up by 3 per cent - considerably more than building society rates; and high interest money-market accounts are spreading rapidly. This greater competition from the banks cannot be ignored. The 3 per cent increase proposed for the gross products would match the banks' deposit rate increases.

(ii) Assuming interest rates now stabilise, and if National Savings inflows failed to pick up adequately, it would be very difficult to raise NS rates again. To do so would be damaging to interest rate expectations. On the other hand, if it turns out in a few months time that we have over-done it, we could always reduce NS rates.

(iii) In view of our current difficulties and uncertain funding prospects - including uncertainties relating to BT - there is a good case for achieving much better NS inflows in the short-run and erring on the side of exceeding the £3 billion target for the year. We can consider how sacrosanct the target is if and when it looks as if we are likely to exceed it.

The main risks are that the package will be unwelcome to the building societies and banks, and that it will be taken as validating or perhaps more than validating - the rise in market rates. But I doubt whether the extra $\frac{1}{4}$ per cent on each of the products compared with the less aggressive package makes much difference in either respect. And the markets should be impressed that we are taking firm action to improve NS performance. There is also, of course,

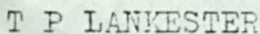
the cost argument, especially in respect of the certificate when we are potentially locked in for 5 years. But in current circumstances I think cost arguments are over-ridden by the need for more quantity.

DNS endorse these proposals. I have also discussed them with the Bank. They are strongly in favour of the more aggressive package, except that they would like the INVAC rate to be higher still at 12½ per cent. Their main argument is that even at 12½ per cent, INVAC will be slightly less attractive than the grossed up rate for 1 month building society deposits of 12.85 per cent (see table 2). Our view is that 12¼ per cent for INVAC is sufficient because -

(i) much of the INVAC money belongs to non-taxpayers; to that extent, the above comparison with building society rates is invalid.

(ii) INVAC has done well in the past without exactly matching the grossed up building society rate. What we are proposing already involves a significant narrowing of the differential - from 1.4 per cent to 0.6 per cent.

(iii) we do not want to narrow the differential between the income and deposit bonds and INVAC. If we do so, potential income/deposit bond money will find its way into INVAC, which is in PSL2 and worse quality funding.



T P LANKESTER

Table 1

NATIONAL SAVINGS NET INFLOW 1984-85

(£ million)

CALENDAR MONTHS

	OUT-TURN			FORECAST			TOTAL
	APRIL	MAY	JUNE	JULY	AUG	SEPT	APR-SEPT
NSC FIXED INTEREST	101	111	85	83	83	80	543
NSC INDEX LINKED	-23	-32	23	-14	-17	-13	-76
INCOME BONDS	85	66	54	55	60	55	375
DEPOSIT BONDS	17	14	10	12	14	14	81
NSB INVAC	50	5	3	2	7	7	74
NSB ORD	1	-1	-3	-1	-1	-1	-6
YEARLY PLAN	N/A	N/A	N/A	NIL	4	7	11
PREMIUM BONDS	9	9	7	6	6	6	43
SAYE	-1	NIL	1	NIL	NIL	NIL	NIL
BSB	-1	-5	-11	-1	-19	-1	-38
TOTAL	238	167	169	142	137	154	1007

TABLE 2

COMPARATIVE INTEREST RATES

Grossed up for basic rate taxpayer or pre-tax (tax-free or net of basic rate tax)

National Savings	Current Rates	Possible Increases		
		Pro-rata to building societies	Course A	Course B
Income Bond	10.0) with effect) from	12.25	13.0	12.75
Deposit Bond	10.0) 3 May 1984	12.25	13.0	12.75
Invac	9.25 w.e.f. 2 April 1984	11.5	12.25	12.0
Conventional NSC	10.4)27th Issue)wef	12.5	13.2	12.9
(tax-free)	(7.25)5 April 1984	(8.75)	(9.25)	(9.0)
Building Societies (majors)	**Current Rates**	**New Rates***		
Ordinary share	8.9)	11.1		
(net)	(6.25))	(7.75)		
7 day money	10.4)	12.5)		
(net)	(7.25)) with	(8.75))		
1 month money	10.7) effect from	12.85) estimated		
(net)	(up to 7½)) April 1984	(9.0))		
3 month money	11.4)	13.2)		
(net)	(up to 8))	9.25)		
Bank 7 day deposit	5.75%-6.0% wef 9 May	6.5%-6.75% wef 6 July	8.75%-9.0% wef from 12 July	

Conventional gilts

	(at close [illegible]/7/84)	
Short	12.773	5 years
Medium	12.426	10 years
Long	11.778	20 years

*The advised share rate announced on 13 July is 7.75%. Consequential new premium rates will be decided by individual societies later. The above premium rates are estimated.

CW

AFTER-TAX REAL INTEREST RATES PAID ON SELECTED FUNDING INSTRUMENTS

Table 3

% per annum

	Income bond + (13.0%)	Invac + (12.25%)	28th issue NSC * (9.25%)	Index-linked certificate*	1988 high-coupon gilt*	1987 low-coupon gilt*	1988 indexed gilt*
<u>3 percent inflation</u>							
Zero marginal tax rate	10.0	9.25	6.25	3.5	9.6	6.6	6.2
30% marginal tax rate	6.1	5.6	6.25	3.5	5.6	5.6	5.5
60% marginal tax rate	2.2	1.9	6.25	3.5	2.0	4.6	4.8
<u>5 per cent inflation</u>							
Zero marginal tax rate	8.0	7.25	4.25	3.4	7.6	4.6	5.9
30% marginal tax rate	4.1	3.6	4.25	3.4	3.6	3.6	5.2
60% marginal tax rate	0.2	-0.1	4.25	3.4	0.0	2.6	4.5
<u>7 per cent inflation</u>							
Zero marginal tax rate	6.0	5.25	2.25	3.3	5.6	2.6	5.6
30% marginal tax rate	2.1	1.6	2.25	3.3	1.6	1.6	4.9
60% marginal tax rate	-1.8	-2.1	2.25	3.3	-2.0	0.6	4.7

+ variable rate

* held to maturity

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DRAFT LETTER

Andrew Turnbull Esq
Prime Minister's Office
10 Downing Street
London W1

NATIONAL SAVINGS

As Adrian Ellis [my] letter of 18 June outlined, National Savings results are badly down on the trend necessary to strike the funding target of £3 billion for 1984-85. We had previously judged it prudent not to take the initiative on improved terms pending the building societies' reaction to interest rate changes which have been occurring in the recent past.

2. The Chancellor has agreed that the time is now ripe, with the building societies announcement on 13 July of an increase of 1.5% in the ordinary share rate, to improve National Savings terms. It is also necessary to take into account the quite sharp increase in banks' deposit rates which have been made much more competitive. He intends therefore to have new National Savings rates announced on 17 July.

3. The new rates, which will start to come into effect from about the beginning of August, exceed, by about half per cent net, the increases announced by the Building Societies Association. This is for a number of reasons:

(a) to be more certain of earlier funding which we need for the front end loaded PSBR, and to get back on to trend to achieve the £3 billion target set for National Savings;

(b) bank deposit rates have increased by 3 per centage points over the last week

(c) to ease any City fears about National Savings not playing its full part in funding in 1984-85.

The Chancellor does not believe the package will be seen as overtly aggressive by the building societies because we are merely restoring some of the competitiveness lost over the last year. Our presentation will centre on the poor National Savings results so far this year and the need to make good the undershoot which we have so far suffered.

4. I should be grateful if you would confirm as early as possible that the Chancellor's proposals have the Prime Minister's endorsement. As I say, the intention is to announce the new terms on 17 July.

16 JUL [illegible]

PERSONAL & CONFIDENTIAL

Your Ref

cc Mr Turnbull
Mr Redwood

with compliments

MR H P EVANS

Treasury Chambers
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Strategy File

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TREASURY ECONOMIC FORECAST

JUNE 1984 REPORT

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TREASURY ECONOMIC FORECAST: JUNE 1984 REPORT

Introduction

This is the report on the (internal) June exercise. Detailed reports are (or very soon will be) available as follows:

World economic prospects, Mr Bottrill (EF2);

Public finances, Miss Peirson (PSF);

Oil production and revenues, Mr Hacche (MP2);

Financial forecast, Mr Mowl (EA2).

2. The budget forecast was completed in the first half of March. Data becoming available since then have been mostly consistent with our earlier forecasts of inflation, output, borrowing, and monetary growth. Differences include higher US interest rates, slightly higher UK rates, and a lower exchange rate. The miners' strike is reducing production now, but there should be some catching up later on.

3. For the world economy we expect, like most forecasters, continued but slower growth in the US (perhaps a recession by 1986) and continued but faster growth in most other countries. We have not allowed for major upheavals in the debt or banking worlds: our forecast looks consistent with these problems slowly getting better, in aggregate. A world of high interest rates and large debts (many of poor quality) has, however, considerable deflationary potential.

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SUMMARY OF FORECAST

4. The next 10 pages summarise the forecast in words and numbers. More detailed sections begin on page 12. A table on pages 9-11 summarises our latest assessment of the UK, alongside the budget forecast. An annex to this forecast provides comparisons with earlier Treasury forecasts and with outside forecasters.

The fiscal prospect

5. The fiscal prospect is set out in some detail in a separate report. Our forecasts of the PSBR and fiscal adjustment compare with the budget forecast as follows:

PSBR

(fiscal adjustment in brackets)

£ billion

	1983-84	1984-85	1985-86	1986-87
Budget forecast/MTFS	10	$7\frac{1}{4}$	7 (2)	7 ($4\frac{1}{2}$)
June forecast	10	$6\frac{1}{4}$	7 (1)	7 (3)

The fiscal adjustments, expressed in annual not cumulative terms, are lower than in the MTFS because public expenditure is higher.

6. The FSBR quoted an average error of £$4\frac{1}{2}$ billion (based on experience of the 1967-83 period) for the PSBR in 1984-85. Errors in more recent years have typically been smaller, equivalent to some £3 billion. The improvement in forecasts between budget time and June is not always large (about 20 per cent on average) though in 1983 the June forecast correctly identified a substantial error in the 1983 budget forecast. Thus the downward revision of £1 billion to the PSBR estimate for 1984-85 and the worsening of the fiscal adjustments in later years are not necessarily of much significance.

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7. The main changes to the PSBR forecast in 1984-85 since the budget are as follows:

i) The forecast of oil revenues has increased by £1¾ billion, reflecting both higher production and sterling prices (both already beginning to be evident in the data).

ii) Higher asset sales (£½ billion).

iii) Higher EC contributions (£½ billion), as a result of a more cautious assumption on refunds.

iv) Higher local authority spending (£¼ billion).

v) Costs of miners' dispute (possibly £½ billion or so).

8. For 1985-86 and later the forecast suggests a slight worsening of the fiscal prospect despite the lower PSBR forecast for this year, mainly because

i) The underlying rise in central government expenditure - offset in 1984-85 only by higher receipts from asset sales - continues.

(ii) Higher debt interest payments next year as the effects of higher interest rates are felt.

(iii) A less marked rise in non-North Sea tax receipts (compared to the budget) in 1985-86 and later, particularly company taxes (reflecting lower profits) and local authority rates.

9. The relationship between expenditure forecasts, the plans in the PEWP (as amended in the budget) and departments' bids in the current survey are explored in the report on public finances. In broad terms, the forecast shows higher public expenditure than in the plans, particularly for later years: the pressures for increases are evident in areas such as local authority spending, nationalised industries, EC contributions, central government cash limits. An important reason for higher than planned spending, particularly in the later years, in the forecast is the assumed growth in public service earnings at 6-7 per cent in 1985-86 and 1986-87, about ½ per cent a year less than in the private sector. There is considerable uncertainty about nationalised industries' EFLs: it is hard to judge prospective pressures partly because of the complications of privatisation.

10. Comparisons between the budget plans and the June forecast are given in the table below:

Planning Totals

cash, £ billion

	1984-85	1985-86	1986-87
PEWP (adjusted for NIS etc)	126.3	131.7	136.2
June forecast	126.7	133.1	139.4

cost terms, £ billion, 1982-83 prices

	1983-84	1984-85	1985-86	1986-87
PEWP/MTFS	114.1	114.2	114.3	113.7
June forecast	114.4	115.7	115.9	115.8

11. The higher cash figures in the June forecast imply that the new Reserve may be overspent in each year especially in 1985-86 and 1986-87. This is after a cash limit squeeze on volumes, equivalent to £0.3 billion in 1985-86, designed to offset in part the effects of higher pay in this forecast. The profile of public spending in cost terms remains fairly flat: with a growing economy and tax revenues rising there is still increasing scope for tax cuts - at least on the public expenditure and PSBR assumptions used in this forecast. The GDP deflators used to derive the planning total figures in cost terms are now showing slightly smaller increases in 1983-84 and 1984-85 and slightly larger increases in 1985-86 and beyond.

Financial forecast

Unless US rates rise more than we have assumed, we think that UK interest rates may not need to rise much or at all from current levels. But the level of rates in this forecast is about a point higher than in the FSBR forecast,

reflecting higher US rates and a lower value of sterling. On the basis of current interest rate levels being broadly maintained for the next year or so (though the mortgage rate is liable to rise soon) growth of £M3 and M0 should stay within their target ranges. Other aggregates, PSL2, M2 and M1 may rise by 10 per cent or so in the current target period. Our judgment is that with real interest rates still high, monetary growth having come down and the exchange rate fairly steady, monetary conditions in the UK are compatible with a very modest fall in inflation over the next year. A slow fall in UK interest rates from mid 1985, especially if the dollar weakens as envisaged, should be consistent with meeting the monetary guidelines.

Inflation and the labour market

The rise in producer output prices, now around 5½ per cent for the index excluding food, drink and tobacco, may slow to 4-5 per cent per cent in the course of 1985, influenced in particular by a steadying of the exchange rate and low inflation in other countries. The RPI inflation rate should soon fall to 4½ per cent, the timing dependent on the vagaries of seasonal food prices (notably potatoes), and this remains our forecast for 1984 Q4. But the rate may edge up for a time in 1985, above the mid-year FSBR figure of 4 per cent.

14. In the labour market, real wages are continuing to rise strongly: the rise has been stronger than expected at the time settlements were made because of unwarranted pessimism over inflation and the achievement of higher rates of productivity growth. But even at present levels of unemployment, pressures to reduce significantly the growth of real wages, and promote the growth of employment, seem to be very weak - much weaker than in the 1930s when from 1933-37 real wages changed little while employment rose by some 3-4 per cent a year.

15. This need not prevent inflation coming down further: but as over the past four years the labour market may play a passive role in transmitting lower price inflation into lower wage inflation, rather than an active role in bringing about lower unemployment.

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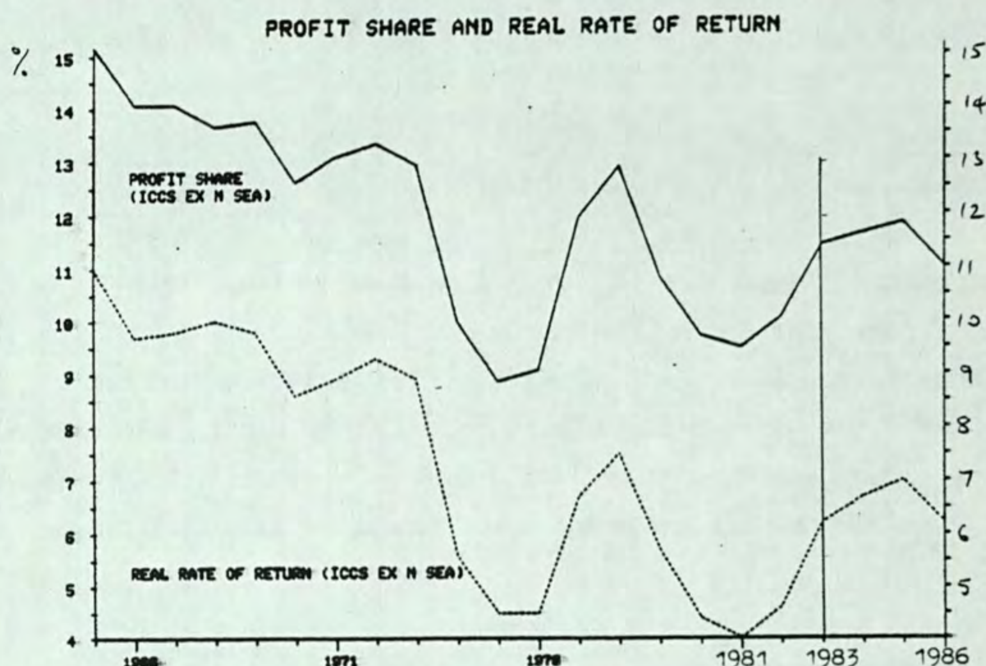
Company sector

16. It is striking that despite the growth in real wages over the past few years, and the faster than expected slowdown in inflation, company profitability and finance have made a major turnround. Helped, particularly in manufacturing, by large productivity gains, the profit share of industrial and commercial companies (excluding the more profitable North Sea operations) is now close to its previous cyclical peaks; and the rate of return (which takes account in addition of the growth in capital employed) is near to 1978 levels:



17. With this turnround in company finance has gone - so far at least - a cautious attitude by most companies. This is expressed in a reluctance by manufacturers to increase employment (increased overtime being preferred); a desire to keep stocks down (so that we see no sign of the usual stock cycle); a low level of investment (despite the sizeable increases signalled by the DTI intentions enquiry); and a high level of liquidity.

18. Some reluctance to spend is understandable given the experience of 1980-81, and the increased returns on financial assets from high real rates of interest. But the potential exists for a sharp increase in spending by companies: we have made some allowance in this forecast and perhaps more than most outside forecasters.

19. Reluctance to borrow and spend has not been characteristic of consumers. Their real incomes are now rising strongly and continue to do so in this forecast as tax cuts add to rising real wages and employment. Consumers should be able to sustain spending increases of some 3 per cent a year in real terms while maintaining their stocks of wealth and a saving ratio of 9 per cent or so.

Money demand and output

20. The external forecasts and the assumptions of a very slow fall in the (planned) PSBR and in the growth rate of the main monetary aggregates points to a continuing slow decline in the growth of money GDP:

	1983-84	1984-85	1985-86
PSBR, percentage of GDP	3¼	2	2
Growth rates:			
£M3)	9½	8	7
) target periods			
MO)	6	6	4½
Money GDP	8	7½	7½

20. Growth of nominal income is generally more stable than that of the monetary aggregates, and consequently somewhat less difficult to forecast. The split of money GDP between quantity and price might be as follows:

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	growth rates, per cent		
	1983-84	1984-85	1985-86
Output	2½	3	3
Prices	5	4½	4½

21. Consistently with the recent rapid increase in profitability, the recovery continues through 1984 and 1985, perhaps tailing off in 1986 with a near-recession in the US and a slowing down in the investment cycle in the UK.

22. We stick to the 3 per cent growth rate for output in 1984: another upward revision to oil production (worth ¼-½ per cent on GDP) broadly offsets the lost output due to the miners' dispute, assumed to end in the summer.

	per cent changes on a year earlier		
	1983	1984	1985
Domestic demand	4½	3	2½
of which consumer spending	4	2½	3
Exports	1	6	4
Total output, GDP	3	3	3
GDP less oil	2½	3	2½

23. The rise in employment since early 1983 was accompanied by a further rise in unemployment, as many of the new jobs were filled by people not on the register. We do not expect much change in unemployment over the next year or two, on the assumption of a more normal relationship between employment and unemployment.

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SUMMARY TABLE AND COMPARISON OF FORECASTS

	FSBR/MTFS MARCH 1984	JUNE 1984
PSBR and Fiscal Adjustment (annual not cumulative) (£ billion)		
1983-84	10	9.7
1984-85	7¼	6¼
1985-86	7(2)	7(1)
1986-87	7(4½)	7(3)
Interest Rates Short-term per cent		
1983-84	9½	9½
1984-85	8½	9½
1985-86	8	9
1986-87	7	8
Money Supply £M3 (% change on year earlier)		
1983-84 target period	9	9½
1984-85 " "	9	8
1985-86 " "	8	7
1986-87 " "	8	6½
Money Supply £M0 (% change on year earlier)		
1983-84 target period	6	6
1984-85 " "	6	6
1985-86 " "	5½	4½
1986-87 " "	5½	4½

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	FSBR/MTFS MARCH 1984	JUNE 1984
World Trade in Manufactures		
(% change on year earlier)		
1983	1	0
1984	5	5½
1985	4½	5½
1986	4½	5
Effective Exchange Rate		
1975 = 100		
1983	83	83
1984	83	80
1985	83	81
1986	83	81
Current Balance		
(£ billion)		
1983	2	3
1984	2	1½
1985	½	2½
1986	1	0
RPI		
(% change on year earlier)		
1983 Q4	5	5
1984 Q4	4½	4½
1985 Q4	(4)	4½

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	FSBR/MTFS MARCH 1984	JUNE 1984
Nominal GDP (mp)		
(% change on year earlier)		
1983	8½	8½
1984	8	7½
1985	7	7½
1986	6	6
GDP Volume		
(% change on year earlier)		
1983	3	3
1984	3	3
1985	2½	3
1986	2	1½
Manufacturing Output		
(% change on year earlier)		
1983	1½	2
1984	3½	3
1985	2	1½
1986	1½	1
Unemployment		
(UK sa excluding school leavers, millions)		
1984 Q1	3.0	3.0
1985 Q1	3.0	3.1
1986 Q1	3.0	3.1

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The World Economy

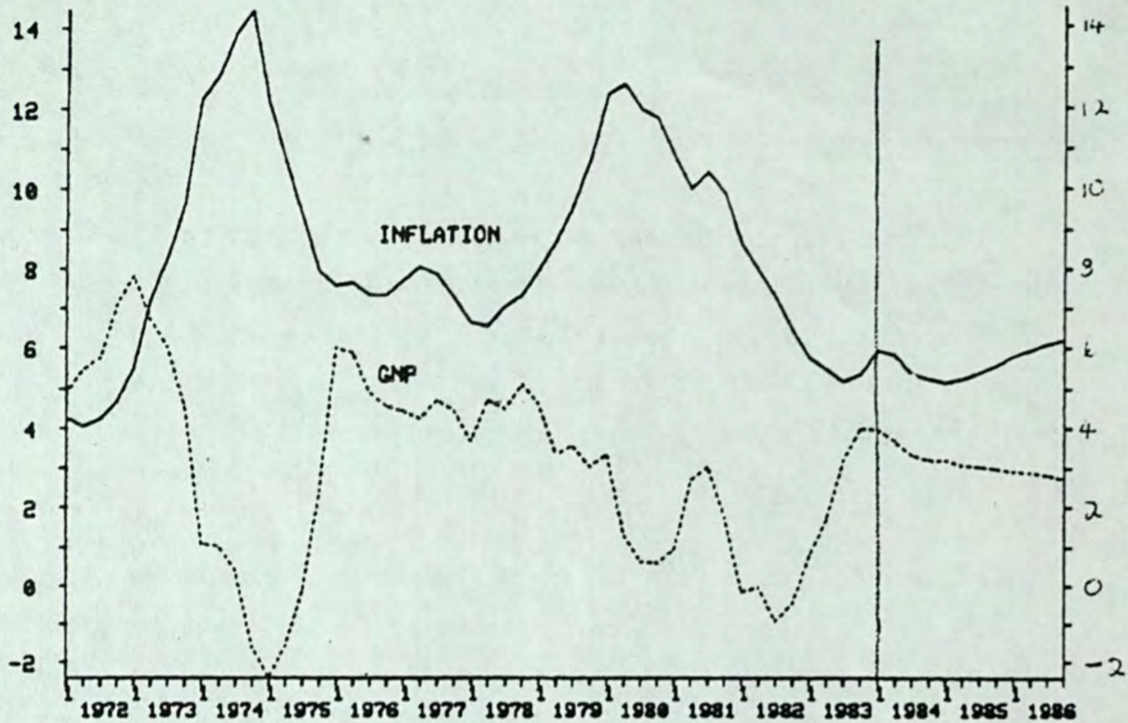
Activity has continued to recover with inflation low in most countries. Our forecast for the world economy has not changed very much since the budget, though US interest rates are distinctly higher and the worries about third world debt and US banking are greater. A full account is given in the report on the world economic prospects, circulated by Mr Bottrill.

We assume that in the US fiscal policy is gradually tightened: that the "down payment" is accompanied by further measures, of about the same size, to reduce the scale of the Federal deficit from some 5 per cent of GDP in 1984 to perhaps 3½ per cent of GDP by 1988. Monetary policy in the US, assumed to give some weight to both debt and banking problems, still produces high interest rates, a little above current levels, for the second half of 1984 and for 1985. Slowly, and with some hesitation, fiscal and monetary policies are assumed to come more into line, at a much higher debt/income ratio and with a somewhat higher rate of inflation. This policy stance, together with a much reduced growth rate of activity (reflecting partly restrictive monetary policy), should allow nominal, and still more real, interest rates to fall, from mid 1985. As a result of these expectations developing, the value of the dollar is liable to fall, perhaps sharply.

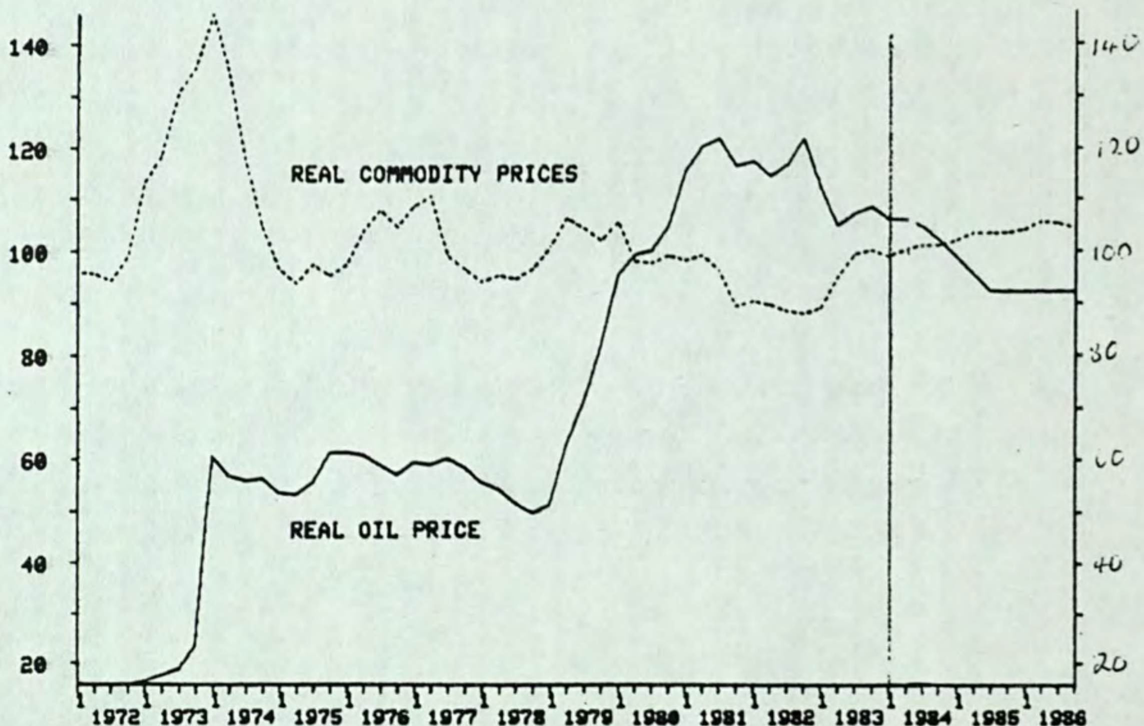
The forecast for output, inflation and trade is summarised in the following table and chart:

per cent changes (Budget forecast in brackets)

	1983	1984	1985	1986
Major 6 output	2½	5 (4)	3	2½
Major 6 consumer prices	4½	5(4½)	5	4½
World trade in manufactures (UK weights)	0	5½(5)	5½	5



Commodity prices show the usual diverse patterns. Oil prices have not reacted much to the intensification of the Iraq/Iran war and we continue to expect (further) falls in real terms, with a constant dollar oil price while the dollar is forecast to fall back , starting in 1985, from current high levels. Food prices (especially cereals, tea, cocoa) are now high and may come back, though the effect on the UK is muted. Industrial materials' prices may show some increases in real terms as a result of the growth in world industrial demand. The chart below provides a summary:



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In this forecast - as in previous ones - the problems of third world debt gradually diminish as a result of:

i) rapid growth in export volumes and no significant worsening in their terms of trade;

ii) a lower value of the dollar and, after 1985, lower dollar interest rates;

iii) resumed moderate flows of private capital;

iv) continued adjustment policies to restrain imports.

In consequence, various measures of the debt problem some show improvement: the real stock of debt falls, the ratio of debt service to export earnings falls etc. None of these highly aggregate measures, even if correctly forecast, can throw much light on whether the debt problems of particular countries can be overcome. A summary of world import growth, by volume, is shown in the table below:

	Share of UK exports in 1983	1973-1979 average	1983	1984	1985
US	14	7	10	24	6
Other industrialised countries	65	3½	2	6	7
OPEC	10	14½	-11	-2	3
Non-oil developing countries	11	6½	-2	6	9
Total*	100	4½	1½	7½	7

*For 1984 and 1985 the forecast growth of total world imports is faster than that shown in the table on page 12, mainly because the UK has a higher weight in some slow growing markets, notably OPEC.

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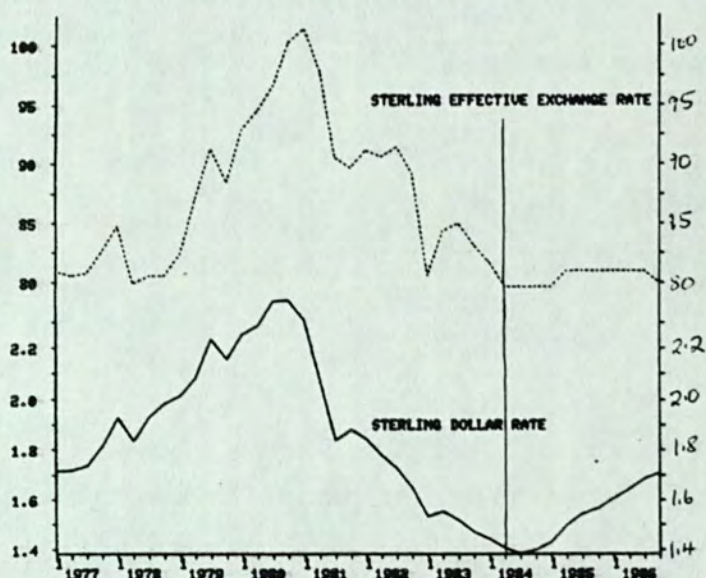
The exchange rate

Over the past year and more, sterling has fallen against the dollar and risen against most European currencies. For some time we have been expecting this pattern to be reversed, but the dollar has remained high. We still expect the dollar to fall - starting perhaps in 1985 rather than this year - once the markets see a prospect of US interest rates levelling out and then falling.

Our projection of no major change in the UK effective rate, at about 80, takes account of forward rates, of the path of oil prices (forecast to be constant in depreciating dollar terms well into 1985) and the continuing surplus on the current account, together with the pattern of interest rates. The forecast fall in oil production after 1985, perhaps accompanied by a move into deficit of the current account, may not yet be fully discounted by the market, and could induce some weakness in sterling. The expected weakness of the dollar could strengthen sterling a little, but by less than the yen and the mark.

STERLING EFFECTIVE EXCHANGE RATE AND DOLLAR RATE



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Trade and the balance of payments

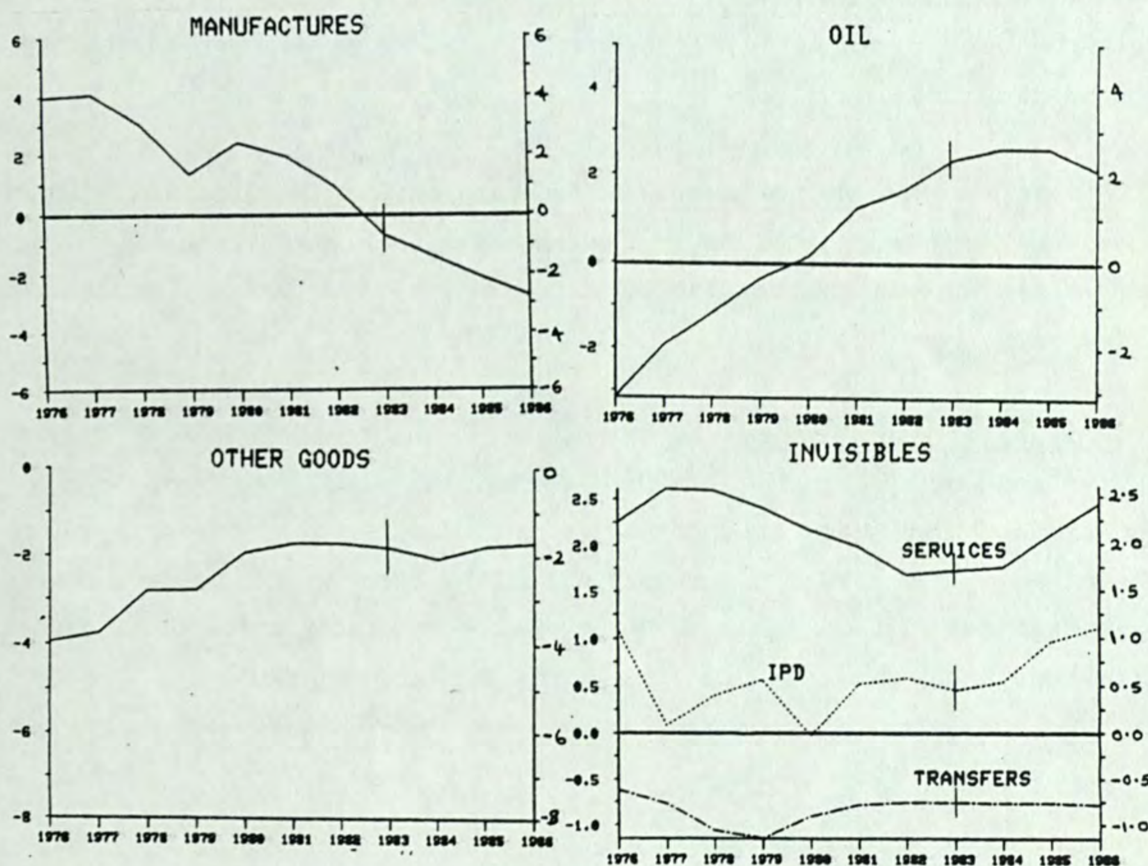
The large current account surpluses in 1980-82, when the UK recession was deeper than the rest of the world, were succeeded by a moderate surplus in 1983. Overall, the current account is expected to remain in surplus for a time, though with substantial shifts in its composition.

These surpluses have contributed, along with asset and currency revaluations, to a sharp rise in the value of the UK's net holdings of foreign assets:

	£ billion	per cent of GDP
end 1979	15	7½
end 1983 (estimate)	56	18
end 1985 (forecast)	75	21

The changing composition of the current account is shown in the chart and table below:

Balances as per cent of GDP
(not on same scale)



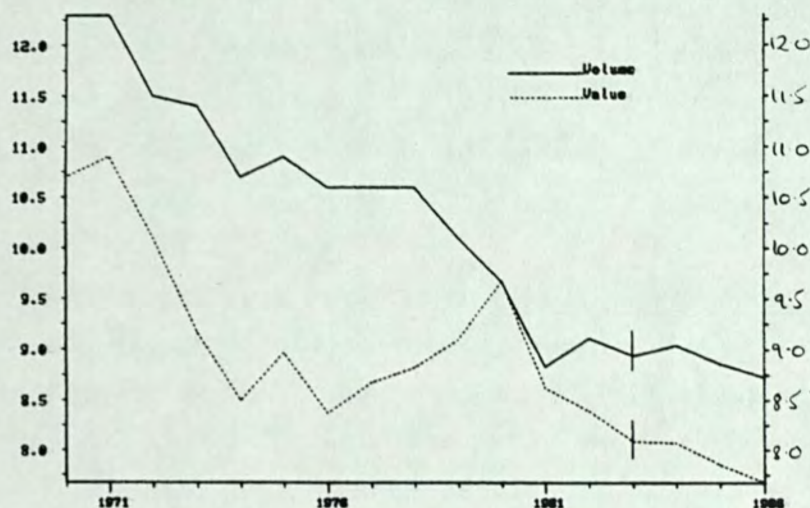
Surpluses and deficits, £ billion

	(per cent of total goods)	1983	1984	1985	1986
Oil	(17)	7	8½	9	7½
Manufactures	(66)	-2	-4½	-7	-10
Other goods	(17)	-5½	-6½	-6	-6
Total goods	(100)	-½	-2½	-4	-8½
Total invisibles		3½	4	6½	8½
Current balance		3	1½	2½	0

The prospects for oil are described in detail in a separate note by Mr Hacche. The slightly higher figure for the oil balance in 1984, compared to that underlying the FSBR forecast, takes account of higher production and prices, partly offset by the extra oilburn resulting from the miners' strike.

The balance on manufactures turned into deficit in 1983, and with import volumes continuing to grow faster than exports, and little change in the terms of trade, we expect the deficit to increase over the forecast period, though less strongly than in 1983.

Exports of manufactures in the three months to April were 9 per cent up by volume on a year earlier, reflecting both the sharp recovery in world markets and what looks like an erratically low level of exports for much of 1983. Over the forecast period, with little contribution from changes in competitiveness, we expect to see a slowly declining share of UK exports in both volume and value terms, in line with long-term trends:



As in other industrialised countries, <u>import penetration in manufacturing</u> in the UK has been on a rising trend for a number of years, as some barriers to trade have fallen and international specialisation has increased (with world trade generally growing faster than industrial production). In addition, domestic demand for manufactures grew strongly in 1983 (probably at a faster rate than at any time since 1973), leading to a pick up in manufacturing import volumes, despite some improvement in price competitiveness:

Per cent changes on a year earlier

	Domestic Demand	Import Price Competitiveness*	Imports of Manufactures (excluding erratics)	Domestic production
1981	-5	11	4½	-6½
1982	1	2½	10	0
1983	7	- 2	11	2
1984	4½	- 3½	11	3
1985	3½	- 3	6½	1½
1986	3½	- 1	6½	1

*lagged one year. Increase represents <u>worse</u> competiteness.

While imports of manufactures volumes are growing strongly at present (in the three months to April they were up 14 per cent on a year earlier) we expect the slowdown in the growth of domestic demand for manufactures, coupled with recent improvements in price competitiveness, to lead to a slowdown in manufacturing import volumes after this year.

The outlook for trade prices is particularly important for the balance of payments, domestic inflation and profitability. As sterling has fallen from its peak in early 1981, both export and import prices have been rising faster than domestic prices. This has helped to restore export profit margins to more normal levels (although they remain some way below their 1977 peak) and has raised import prices relative to those for domestically produced goods. In our judgment, this recovery is now substantially complete, at least for manufacturing, provided that current levels of the effective exchange rate are maintained, and domestic costs grow more in line with our competitors.

Perhaps one of the surprising features of our trading patterns in recent years has been the stability of our terms of trade: between 1980 and mid 1983, these remained virtually unchanged, despite a fall of 12 per cent in the effective exchange rate. There were a number of reasons for this:

(i) World commodity prices (excluding oil) fell in real terms in 1981 and 1982.

(ii) The pattern of exchange rate movements was on balance favourable to the UK: in particular, while the fall of sterling against the dollar and the yen helped export volumes, its strength against the continental currencies kept import prices in check - though the strong dollar probably helped to sustain real oil prices.

(iii) As usual when the exchange rate falls, importers were willing to reduce their profit margins, and exporters to increase them. Moreover in the case of basic materials, importers seem to have had abnormally

high margins in 1980, which allowed them to keep import prices virtually unchanged in 1981 and 1982.

Some of these factors have now started to unwind: world commodity prices (excluding oil) have tended to increase in real terms as world industrial production picks up, and recent exchange rate movements have led to some acceleration in import prices. As a result the terms of trade have declined by 3 per cent since their peak in the third quarter of 1983. Nonetheless the slower growth from now on in import prices, as the exchange rate is assumed to stabilise, is an important influence on the path of domestic inflation. Weakness in the real oil price through 1985 is also a help. In total, import prices (including oil) are forecast to rise 4-5 per cent a year from now on, compared with 7-8 per cent in 1983 and 1984 (first half).

The invisibles balance in 1983 was running at a lower level, in relation to GDP, than for most of the 1970s. In part this reflects the build up of IPD debits on oil (a partial offset to the gains on oil in the trade statistics), but it also reflects the influence of a strong pound and sizeable competitiveness effects on services, and the continuing decline in the UK merchant fleet. The growth of overseas assets has shown up only weakly in higher IPD earnings, implying a low return on assets; this may be partly a problem of inadequate statistics (revisions to IPD data tend to be upward) as well as a tendency to invest in assets with a low current return. We expect strong growth in both services and IPD earnings over the next few years, with the recent changes in competitiveness contributing to the strong rise and in service volumes. The balance on transfers is not expected to change much over the forecast period, although the more cautious assumptions now being made on EC transfers have lowered the balance for 1984 by over £300 million.

Overall, the growing deficit on manufactures and the falling surplus on oil may offset the rise in invisibles and the smaller deficit on other goods. By 1986 this could result in the current account moving towards and perhaps into deficit.

Demand and activity

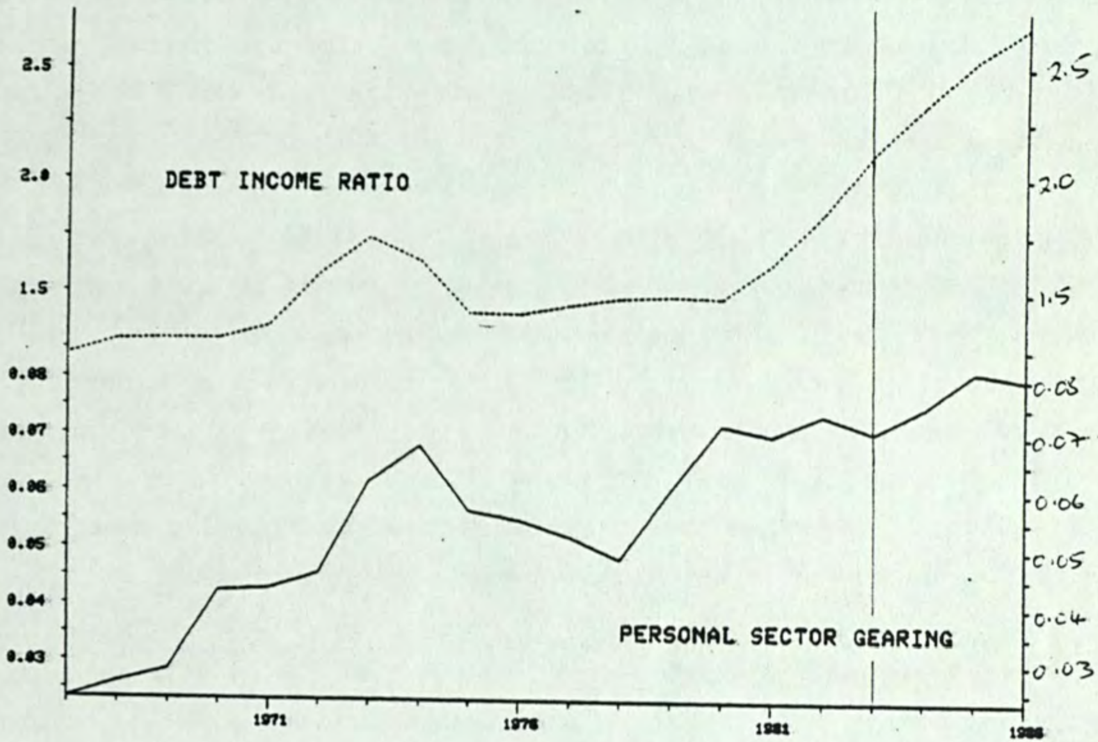
Personal sector expenditure has grown strongly over the past two years: initially there was a reduction in saving; only over the past year have real incomes risen strongly.

The reductions in the saving ratio and increased expenditure on housing have been more than financed by substantial increases in consumer borrowing. As banks have moved into the housing market, and building societies have adjusted to increased competition, personal sector indebtedness has far outstripped the growth in disposable incomes:

	Banks and building society lending (net increase, £ billion)	Percentage change in stock of bank and building society lending	Percentage change in personal disposable income
1981	13	25	$8\frac{1}{2}$
1982	18	32	8
1983	$19\frac{1}{2}$	26	7
1984 (forecast)	$21\frac{1}{2}$	19	8

Some of this borrowing has offset other forms of credit. Part has helped to build up stocks of financial assets - perhaps because the liberalisation of the financial system has encouraged borrowers to move to cheaper sources of finance and has allowed households to correct previously distorted portfolios. But the ratio of personal sector debt to income has now risen so far above past experience - mostly periods of control over lending - that we have little to guide us on the potential limits. Lower interest rates have nevertheless helped bring down the costs of servicing the debt, so that (the uncertainly measured) personal sector

gearing ratio looks less exceptional:



The area most obviously associated with this expansion of credit has been expenditure on consumer durables (particularly cars and white and electrical goods). Typically, strong cycles in durables occur during periods of fast increases in real disposable income and when credit conditions ease. This time, the expansion started when real incomes were basically flat and when nominal interest rates were falling, though real interest rates remained high. The conventional allowances for the effects of removing HP controls are much too small to explain the size of the boost to expenditure; and it

seems unlikely that the effect on real balances of falling inflation rates or revaluations would, in themselves, have been large enough. It looks as though a mixture of improved confidence, a depleted stock of durables, large relative price changes and perhaps distributional effects (substantial after-tax rises in real income amongst those in work) have generated a strong cycle. The process has been made possible by the lifting of constraints on the financial system, so that the banks have had incentives to supply credit to those previously unable to raise their stocks of physical assets to desired levels.

For the forecast, the main issue is whether a period of rising real personal disposable income accompanied (perhaps by late 1985) by falling interest rates will serve to extend the durable boom beyond normal lengths. While some of the current signs are adverse (the fall in expenditure in the first quarter, the assessments by the car industry of little or no growth in sales volume this year and reports of a falling-off in some electrical goods sectors) we stick to our assessment of continued underlying growth, though at much slower rates than over the last two years.

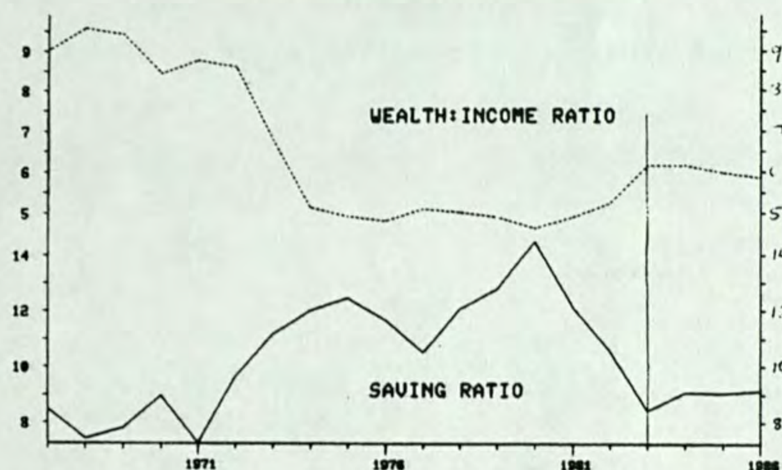
Consumer spending on non-durables has been rising at 2 per cent a year, partly reflecting the effects of inflation on the saving ratio. Future gains from this direction will be smaller and non-durable expenditure is expected largely to follow the path of real disposable income.

Percentage changes

	Volume of Consumer Expenditure		Real personal disposable income	of which due to fiscal adjustment
	Durables	Non-durables		
(Weight in 1980)	(10)	(90)		
1982	8	½	-½	
1983	16½	2½	1½	
1984	3	2	3	
1985	5	3	3	0
1986	1	3	3	1½

Rising equity and bond prices, a lower rate of inflation and modest rates of investment have led the personal sector to rebuild its stock of financial wealth in recent years despite declining saving ratios. Little further change is expected in the forecast period. With large increases in mortgage lending and lower interest rates the recovery in the private housing market, in terms of investment or prices, has not been exceptional. We expect a fairly modest recovery to continue.

SAVING RATIO AND WEALTH:INCOME RATIO

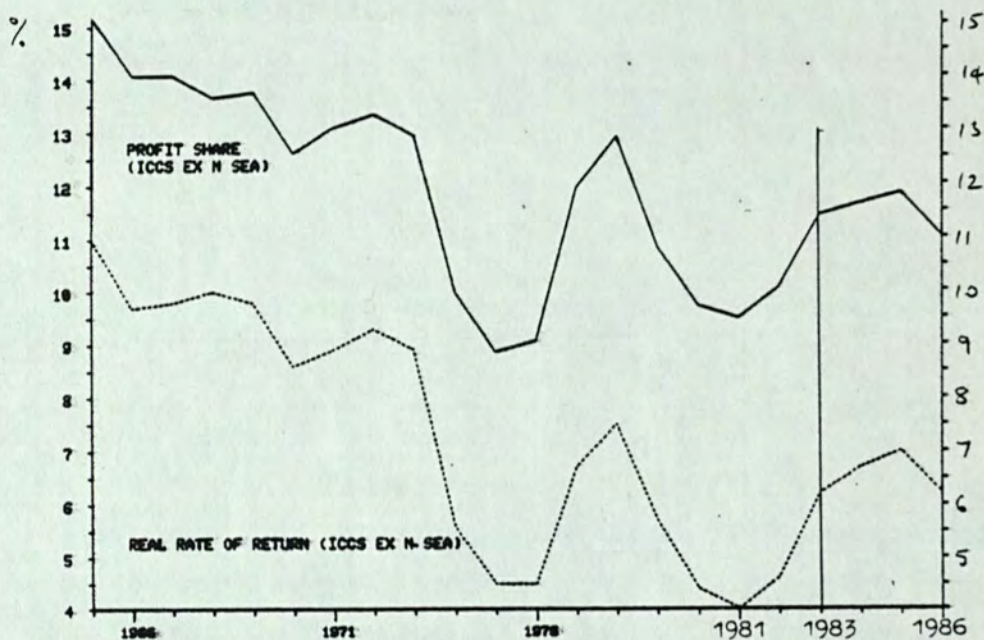


The process of adjustment to lower rates of inflation and smaller public sector deficits involved considerable changes in company sector behaviour between 1979 and 1981-82. Particularly in manufacturing, profit margins were cut substantially, employment was reduced and expenditure on stocks and investment curtailed. The last year has seen a major recovery in profitability and an upturn in manufacturing investment. Employment has turned around - at least outside manufacturing - and the period of destocking seems to be over, even if there is little sign of much rebuilding of stock levels.

On most measures, the company sector now seems to be in a comfortable position in historical terms. Real rates of return for the whole non-North Sea industrial and commercial sector are estimated to be back at their 1978-79 levels, consistent with the substantial recovery in the share of profits in GDP. The sector ran an enormous financial surplus in 1983, with borrowing needs that seem currently fairly modest. And their liquidity is virtually at record levels.

Rate of Return and Profit Share

(Industrial and Commercial Companies less North Sea)



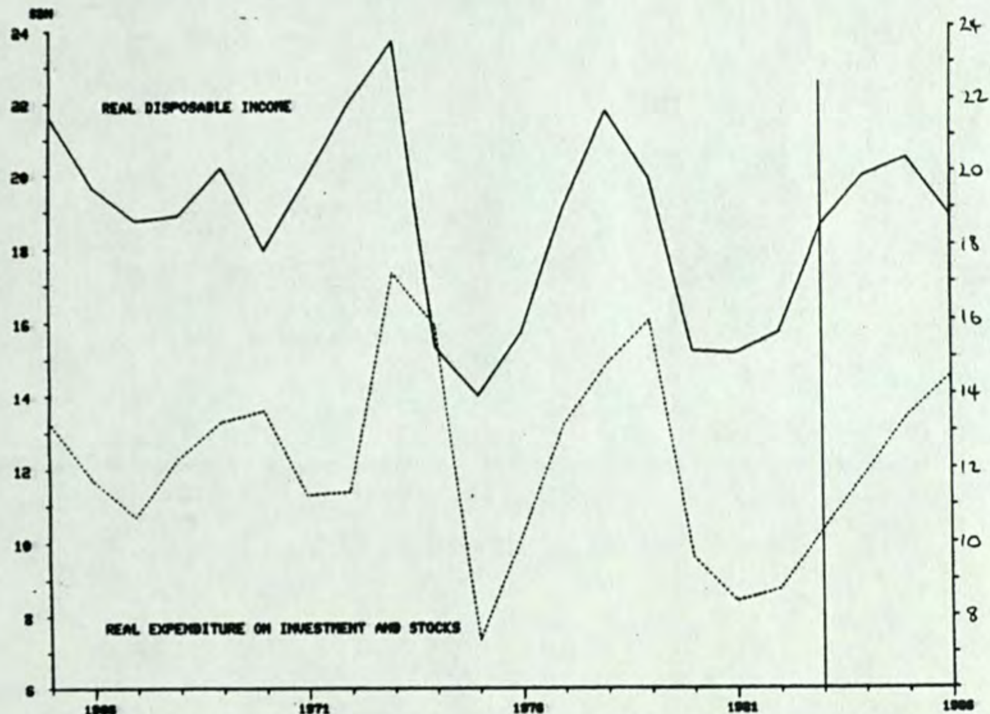
But the data in this sector are notoriously unreliable: figures for financial transactions indicate a much less buoyant (though still good) situation compared with National Accounts data. Higher nominal rates of interest and lower effective margins being charged by banks also provide incentives for companies to build up their stocks of (gross) liquid assets, aided by the increased dependence this cycle on leasing activity.

For these reasons, the forecast takes a relatively cautious view on the possible implications for spending of ICC's current financial position. There are undoubtedly incentives for higher investment in the form of improved returns. But companies seem to hold fairly modest expectations

about the sustainability of current rates of output growth. And it may be that we are seeing, in manufacturers' reluctance to take on new labour or to allow their stock levels to rise, a determination not to return to the financially exposed positions of the early and late 1970s. With higher profitability they are of course more vulnerable to upward pressure on wages - but, again, improved liquidity increases their capacity to withstand industrial disputes. The forecast foresees a maintenance of recent higher levels of real disposable income but expenditure, responding with a lag, not rising quite as fast as in previous cycles.

Income and Expenditure

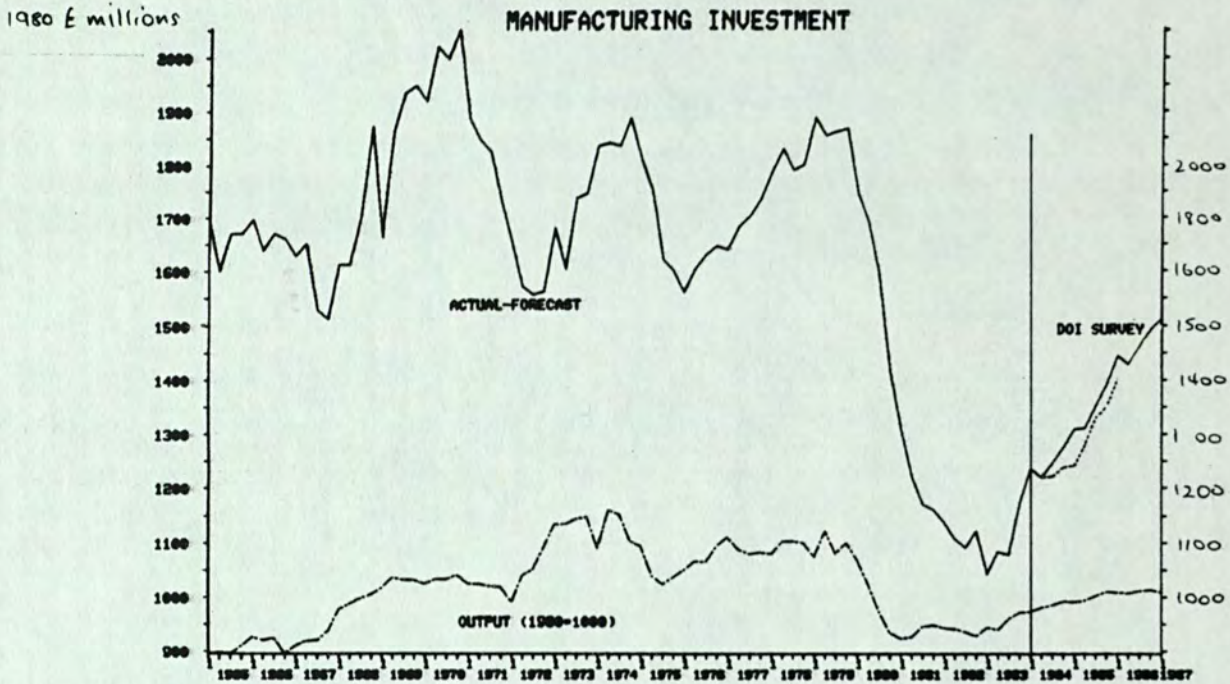
(Industrial and Commercial Companies less North Sea)

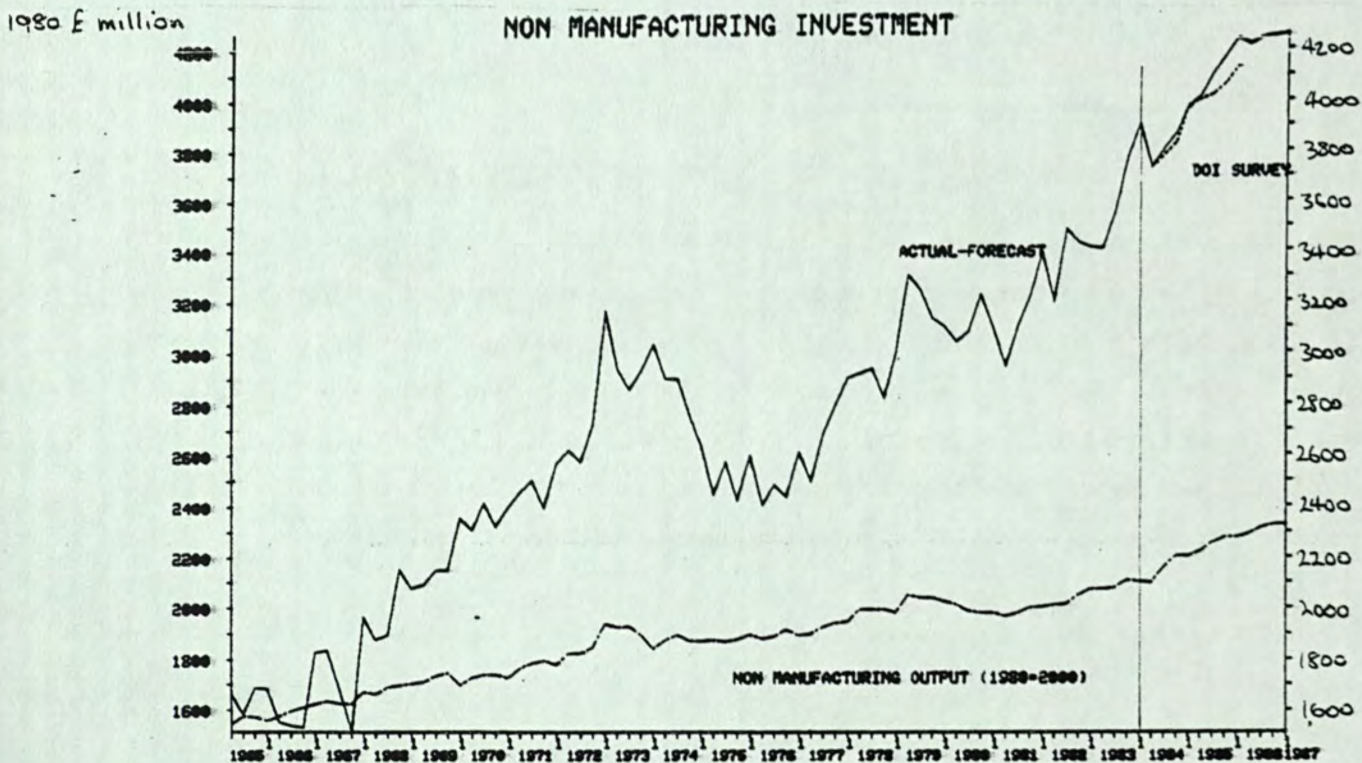


The difference between the income and expenditure lines above reflects dividend distributions and financial surplus. Further growth in dividends seems likely in 1984 and 1985. Abstracting from recent setbacks it is likely that the underlying state of the stock market, accompanied by better profitability of firms and increased takeover and merger activity, will provide additional incentive for companies to distribute earnings.

All recent surveys point to a substantial rise in business fixed

investmnent this year. Even before the incentives provided by the corporate tax changes in the budget to bring forward expenditure into the current financial year, the prospects were for a marked recovery in the manufacturing sector as output and profitability improved. Including an allowance for the effects of the budget, the increase is now put at about 14 per cent, continuing at a rate of growth of about 7 per cent into 1985. This is not, however, exceptional by historical standards and will leave the level of investment fairly low in both absolute terms and relative to manufacturing output.





Outside manufacturing, the recession seems to have had little impact on total investment, bolstered by a very strong performance in some sectors, notably financial property, retail trade and the rental industry. Further strong growth is expected in the retail sector this year. With improvements also likely in construction and road transport and with the advent of cable, investment is likely to continue increasing at 5-10 per cent per year.

Despite new computerised techniques and the high nominal costs of borrowing, stock-output ratios rose steadily through the 1970s - perhaps because of increased uncertainty about the availability and price of supplies, the impact of the stock-relief scheme and the lower real cost of holding stocks. But the evidence so far is that this process may now be in reverse. It is difficult to separate out underlying from cyclical influences, but recent behaviour and surveys suggest a strong desire not to allow stock-output ratios to rise above current levels. The budget changes and the high real return available on financial assets will reinforce this. Only outside manufacturing, where stocks of consumer goods may have been brought below desired levels by the strength of expenditure on durables, are we expecting to see any significant rebuilding of stocks.

Demand and activity summary)

The prospects for domestic demand (at constant prices) are summarised in the table below:

	per cent changes on a year earlier			
	1983	1984	1985	1986
Personal consumption	4	2½	3	2½
Public consumption	2	1½	½	0
Public investment*	7	-4	-3	0
Private investment*	4	11	4	4
Change in stockbuilding (as per cent of level of GDP)	1	0	0	0
Total domestic demand	4½	3	2½	2

The substantial growth in exports expected in 1984 and 1985 is forecast to offset the slowdown in the growth of domestic demand. By 1986 the fall forecast for oil production is reducing exports of oil by 10 per cent or so.

	1983	1984	1985	1986
Domestic demand	4½	3	2½	2
Exports of goods and services	1	6	4	1
Imports of goods and services	5	7½	3½	4
Domestic production: GDP	3	3	3	1½
Manufacturing	2	3	1½	1

*Excluding the effects of council house sales and privatisation.

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The **miners' strike action** began on March 12. About three-quarters of pits were idle in April, apparently representing a loss of nearly 70 per cent of the output of the coal and coke industry, itself normally about 4 per cent of industrial production. The effect on the level of industrial production in April was a reduction of $2\frac{3}{4}$-3 per cent. There has been a further loss in the electricity production industry where, although gross output is unaffected, net output is reduced because the oil being used as an input is of a higher price than the coal it replaces. This second loss is not yet apparent in the published industrial production figures but we estimate that making allowance for both this and the loss of coal output is likely to reduce GDP in the second quarter by about $1\frac{1}{4}$ per cent from levels it would otherwise have reached.

The table below gives an estimate of what the loss of GDP will be in 1984 assuming a partial recovery of lost output in the summer and autumn after the end of the strike. Stocks are gradually rebuilt later this year and during 1985 but that part of output which was replaced by an increase in imports is permanently lost. The net effect is to reduce the level of GDP in 1984 by $\frac{1}{2}$ per cent but to raise the growth rate by a little more than $\frac{1}{2}$ per cent in 1985 as some of the output loss is made good. Underlying growth continues to be steady during the course of 1984 although the forecast path including the strike effects is more erratic.

Effects of the miners' dispute

£ billion (percentage changes in brackets)

	1984	1985	1986
Domestic production reflected in	- 1.1 (-0.5)	+ 0.3 (0.1)	+ 0.1
Stock change	- 0.4	+ 0.3	+ 0.1
Increased imports	- 0.7	0	0

The path of GDP, for the past, is measured by the average measure of GDP. (The output measure probably gives a better indication of changes between one quarter and the next, especially in the most recent periods).

The estimated effects of the miners' dispute and of North Sea oil and gas production on the total GDP can be seen in the following table:

1980 = 100, and per cent changes on a year earlier

	1982	1983	1984	1985	1986
GDP average measure	100.5 (2.0)	103.5 (3.0)	106.5 (2.9)	109.5 (2.9)	110.9 (1.3)
GDP <u>less</u> contribution of N Sea production	99.4 (1.3)	101.9 (2.6)	104.3 (2.3)	107.4 (3.0)	109.5 (1.9)
GDP <u>less</u> effects of miners' strike	100.5 (2.0)	103.6 (3.0)	107.1 (3.4)	109.4 (2.2)	110.9 (1.4)
GDP <u>less</u> contribution of both oil and miners' strike	99.4 (1.3)	102.0 (2.6)	104.8 (2.8)	107.3 (2.3)	109.4 (2.0)

The growth of oil production has accounted for half a per cent a year of the growth of GDP for the last four years but a forecast contraction in 1985 and 1986 is expected to reduce growth. It should, however, be recognised that future levels of oil production are particularly uncertain.

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Employment, labour force and unemployment

Total employment has been rising since early 1983. Evidence from the 1983 Labour Force Survey helps to confirm the size of the DE allowances for undercounting, reflected in the supplementary series for the employed labour force. By the first quarter of 1984 this was perhaps 250 thousand up on a year earlier.

Within this total, employment in manufacturing fell 120 thousand, or about 2 per cent. With output rising by 3 per cent, output per man rose 5½ per cent. Average hours worked rose 1½ per cent, and output per man hour rose 4 per cent. The rise in average hours reflects a substantial reduction in short-time working and an increase in overtime which has brought both overtime per operative and the proportion of operatives working overtime well above average levels. This suggests, as often happens at this stage of the cycle, a cautious policy on the part of firms: unsure about the duration of the recovery, they may see a future drop in overtime as an easier response to a falling off in orders than laying off more employees. But if, as we expect, the recovery is sustained then future increases in demand for labour should take the form of higher employment (compared to what it would otherwise be) rather than yet higher overtime. This is reflected in our forecast of growth in output per head which slows significantly through 1984 and 1985.

Our judgments on productivity growth are set out in the table below.

Manufacturing, per cent changes on a year earlier

	Output	Output per head	
	Average	Trend	Actual
1964-73	3.0		3.9
1973-79	-0.7		0.8
1979-81	-7.5		-0.2
1981-83	1.0	3.5	6.4
1984)		3.2	4.6
1985)	1.9	3.1	2.6
1986)		3.0	2.5

There is little doubt that the fast productivity growth in the period 1981-83 reflected, in part, cyclical recovery. But part also reflects, we think, a speeding up of the trend compared with the (very slow) seventies. This may have been partly due to more rapid adoption of new technology but it seems likely that there have also been permanent improvements in the utilisation of the labour force (less restrictive practices, less waiting time). Although financial pressures on companies, intense in 1980, have turned round almost completely, the large gap between UK and eg German productivity levels together with perhaps some shift in management attitudes suggest to us only a very modest easing in underlying productivity growth in manufacturing. Growth in real wages is forecast to continue quite strongly; there is little sign of the labour market delivering the substantial fall in real labour costs that would be required to produce an appreciably better employment picture.

Outside manufacturing, where there is little evidence of unusual productivity growth this cycle, the employment forecast is dominated by the growth in output which, forecast at 3 per cent average for 1983-86, looks to be comfortably ahead of the rise in productivity. All this suggests that total employment in the economy may rise by some 150 thousand ($\frac{1}{2}$-$\frac{3}{4}$ per cent) a year over this period.

Since early 1983 employment has risen by perhaps 250 thousand; and unemployment (claimants), after allowing for the effect of the 1983 classification changes, has also risen by 150 thousand. Adding these two together gives the <u>working population</u> which may have risen by 400 thousand. This is much larger than the increase in the <u>labour force</u> which DE had projected on the basis of demographic factors and likely movements in participation rates. But:

(i) not all those people looking for work are claimants

and

(ii) not all claimants are looking for work.

Estimates of the labour force attempt to take account of both these factors by counting the numbers employed and the numbers who, while not

employed, are looking for work. Clearly there are great difficulties in distinguishing between those loking and not looking for work; and the boundary will be affected by economic circumstances, most of all by the opportunities for employment.

An interpretation of the last year or so is that the extra jobs, many of them part-time jobs in service industries, were filled by people not on the unemployment register and by new entrants to the labour force; while the continuing job losses in manufacturing and elsewhere helped increase the numbers registered as unemployed (some of whom, no doubt, had virtually given up searching for work). Over the forecast period we expect growth in the population of working age to contribute about 100 thousand a year to labour supply growth. With some continuing increase in female partipation rates the labour force could rise by 125 thousand a year in total. If we are right in our forecast of employment rising by 150 thousand a year, then there is only a small gap which may be filled partly by taking in people not on the register and partly by people coming off SEMS. With wide margins of error on all the elements, our forecast of unemployment is basically for little change.

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Inflation

Some of the main competitive and cost influences on UK producer prices are shown in the following table:

per cent changes, in sterling, on a year earlier

	Prices charged by foreign manufacturers in the UK	Costs of UK manufacturers		UK producer prices*
		labour (including NIS)	imports	
1983	10	1½	7	5½
1984	8½	4½	10	6
1985	4½	4½	7	5½
1986	3½	5½	6	4½

*excluding food drink and tobacco

Abroad, inflation is generally low and this is reflected in low increases in the prices of imported manufactures in the UK from 1985 onwards, once sterling has as we assume stabilised. At home, costs are well under control, rising more slowly (with the help of NIS cuts) than prices. Capacity utilisation in manufacturing, as measured by the CBI regular surveys, is about average. In these circumstances, UK producer prices may rise a little more slowly in 1985 and 1986. Even so there should be some scope for further increases in profit margins for a time, though slower growth in the economy by 1986 may lead to the usual cyclical downturn in the profits share.

The RPI so far has turned out close to the budget forecast, despite the higher than expected April increase. Our forecast of the components is given in the table below (budget forecast in brackets):

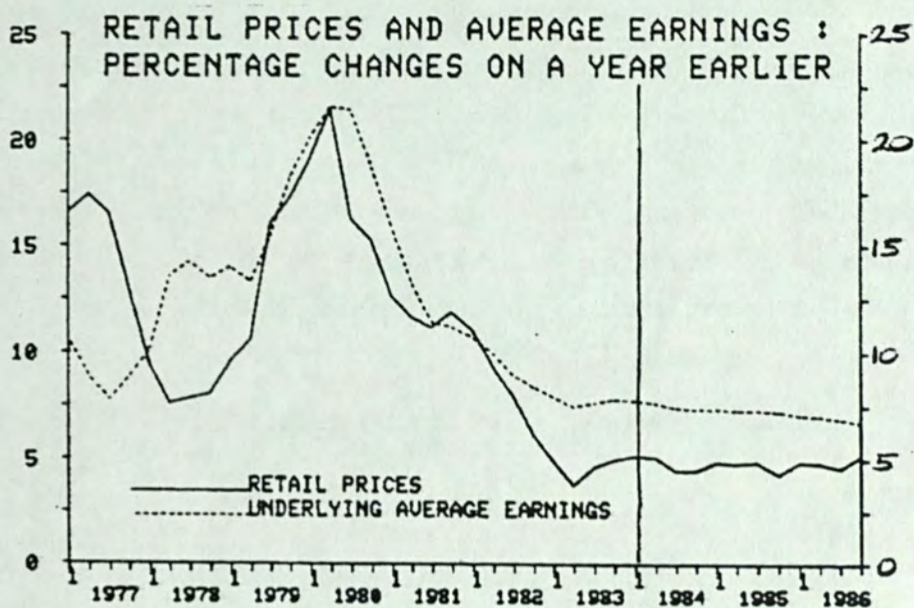
	Weights in total	per cent changes on a year earlier 1983 Q4	1984 Q4	1985 Q4
Food	20	6	4(3)	3½
Housing	15	6½	6(7)	4½
Nationalised* industries	9	1½	4(3½)	3
Other	56	5	4½(4½)	4½
Total	100	5	4½(4½)	4½

*including BT

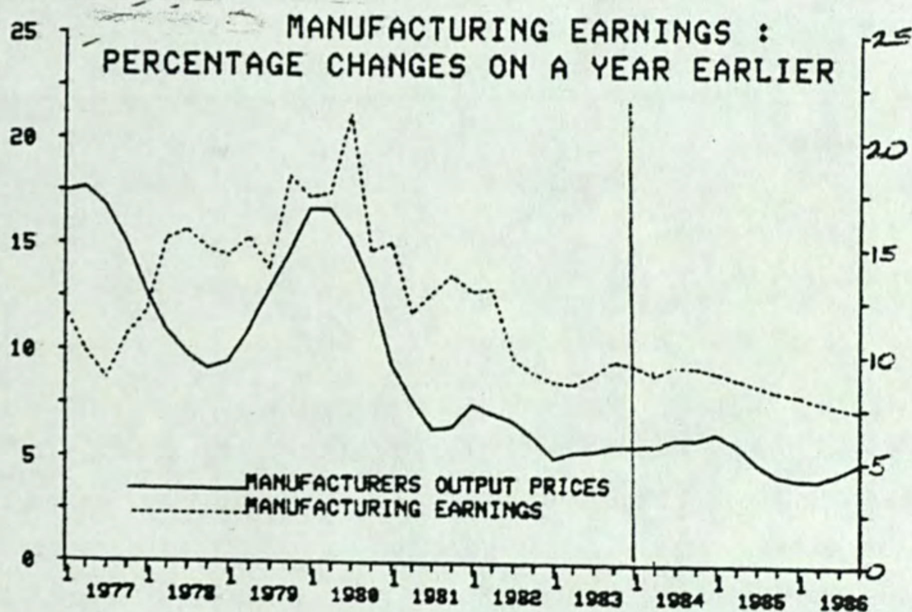
The forecast for Q4 1984 remains at 4½ per cent; other forecasters, though still averaging 5-6 per cent, are tending to come down. Our view of mid 1985 (4½-5 per cent) is a little higher than the budget forecast of 4 per cent reflecting higher import prices (mainly a lower pound) and higher interest rates.

The relation between prices and earnings in the whole economy and in manufacturing is shown in the charts below:

A. Total economy



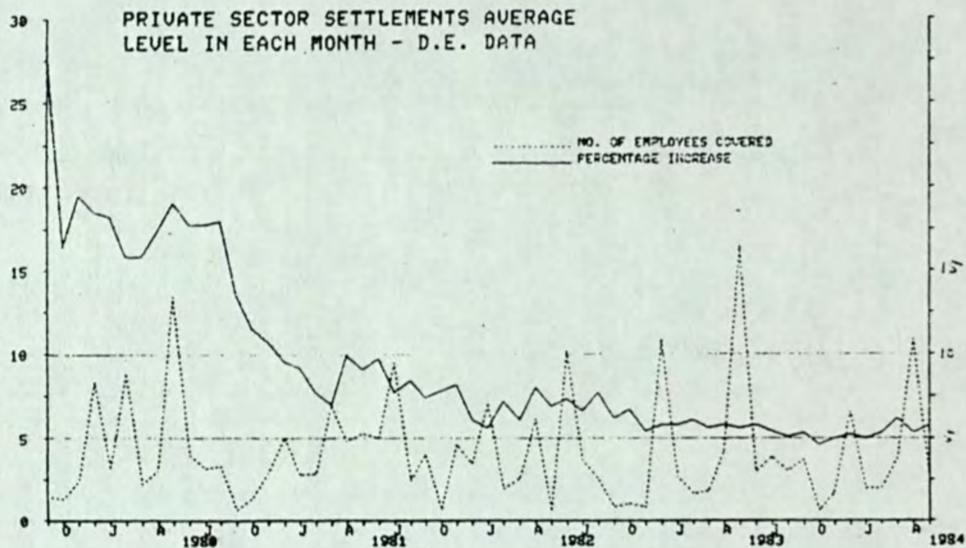
B. Manufacturing



*For the whole economy we use the DE's 'underlying' earnings series which attempts to remove the effects of strikes (including miners), back pay etc.

Earnings: background

Wage inflation has not changed much since late 1982: wage settlements have run at 5-6 per cent; and annual earnings increases have been fairly steady in the range $7\frac{1}{2}$-9 per cent. In manufacturing, earnings increases, underlying, and after allowance for changes in hours worked, have been in the range 8-9 per cent since August 1982. The chart below shows wage settlements over recent years, together with an indication of the proportions settling in each month, based on unpublished DE data.



The table overleaf shows the development of wage settlements, earnings and inflation over the last four pay rounds. Throughout this period, inflation turned out lower than outside forecasts; real earnings turned out higher than expected. Wage bargainers were prepared, in the period to summer 1982, to conclude settlements that provided for earnings increases <u>lower</u> than the expected rise in prices. Subsequently, autumn 1982 onwards, settlements were expected to lead to earnings growth only modestly ($1\frac{1}{2}$-2 per cent) above the level of expected inflation. But prices again rose less than expected and the cumulative difference over 3-4 years amounted to over 5 per cent.

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EARNINGS, INFLATION AND ANTICIPATED REAL EARNINGS GROWTH: WHOLE ECONOMY

percentage changes on a year earlier

	pay round				
	1980-81	1981-82	1982-83	1983-84 Estimates	1984-85 Forecasts
Wages					
Settlements outcome	8½	7	5½	5¼	
Underlying average earnings increase(a)	11½	9¼	7½	7½	7½
Inflation					
Outside forecasts for Q4 made in autumn of preceding year (b)	11.7	9.8	6.1	5½	[5-6]
Outturn (c)	11.9	6.2	5.1	4½	4½
Real gross earnings increase					
Anticipated (a-b)	-¼	-½	+1½	+2	2
Actual	-½	+3	+2½	+3	3
Real net earnings increase	-2½	½	+2½	3	3

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Thus employees received higher than expected real wages before tax. But after tax and NIC increases in 1980 and 1981, the position is less clear: certainly in 1980 and 1981 tax and NIC increases led to a gap of 2-3 per cent or so in both years between gross and net earnings (see table). In the autumn of 1981 the level of wage settlements implied a small fall in real take home pay given the prevailing and prospective rates of inflation, after allowing for the sharp increase in taxation already announced in the 1981 Budget. But in 1982 and 1983 the level of wage settlements provided for an increase in real wages.

Although prices rose more slowly than forecast, the financial position of companies improved rapidly from the summer of 1981, and more than expected, helped by:

(i) large productivity increases, above all in manufacturing, partly induced by the high cost of labour;

(ii) the UK's terms of trade which turned out better than expected, increasing the real income of both employees and employers;

(iii) successive cuts in NIS.

These factors - particularly the coincidence of higher than expected real wages (for those in work) and higher than expected profits and company income - go a long way to explaining why the differences from expectations at the end of each pay round for both prices and real wages were not a major factor in the next set of negotiations.

The conclusion is that the disasters of 1979-80 led the labour market to deliver small falls in expected real earnings (before tax) in 1980 and 1981. But when these did not materialise, the pressure to correct earlier mistakes in subsequent wage negotiations proved weak.

Earnings: forecast

The current, 1983-84, pay round seems to be delivering settlements averaging $5\frac{1}{4}$ per cent, with earnings growth of about $7\frac{1}{2}$ per cent overall ($\frac{1}{2}$-1 per cent lower in the public services).

We expect price inflation as measured by the RPI to be around $4\frac{3}{4}$-$4\frac{1}{2}$ per cent in the autumn of 1984 and to stay about that rate in 1985. Outside forecasts for inflation in 1985 may by then be around 5 per cent or more. On the employers' side import costs may be rising at about 5 per cent from now on and the effect of wage costs on prices will be ameliorated by the cut in NIS as well as by a continuation, though perhaps at a slightly slower rate, of the recent large increases in productivity. The prices of competing imports, now some 8 per cent up on a year earlier, may be rising by only 3-4 per cent through next year. This would not allow a relatively large increase in wage costs to be passed on in higher price rises without loss of market share. But the rate of increase in private sector output is expected to continue to be buoyant at around 3 per cent; and company sector income in real terms may still be increasing. All these factors suggest that further increases in real earnings (pre-tax) are likely to be implied by wage negotiations and the outcome may again be better than expected if

a) prices rise more slowly than expected;

b) the fiscal adjustment in 1985-86 and beyond is used, as this forecast assumes, to cut personal taxes.

This is despite the considerable degree of spare capacity in the labour market, shown by the CBI survey results in the table below:

CBI Survey: Factors likely to limit output

Percentages

	April 1979	April 1981	April 1983	April 1984	Long-term average
Skilled labour	23	2	4	8	22
Other labour	6	0	1	1	7

All this suggests an earnings outcome in the 1984-85 pay round close to 7½ per cent, as in the current pay round. Thereafter the evidence of inflation remaining low (assumed by then to be reflected in outside forecasts) and the big increase in after tax real earnings, helped by the assumed tax reductions in successive budgets, should gradually bring down settlement levels and rates of earnings growth.

Our basic judgments relate to private sector earnings. We assume nationalised industries get the same. For public services we assume that earnings growth will be about ½ per cent a year less than in the private sector in each year. Because there is usually less drift in the public services this assumption on earnings implies that some public service settlements will be higher than in the private sector - as is the nurses' settlement just announced.

Percentage changes on a year earlier

Summary table: settlements and earnings growth

	Private sector & nationalised industries	Public services	Total
pay rounds (September-August): settlements			
1983-84	5¼	5½	5¼
1984-85	5½	5½	5½
1985-86	5	5½	5
financial years: earnings growth on previous year			
1983-84	8	6½	7½
1984-85	7½	6½	7½
1985-86	7½	6½	7½
1986-87	6½	6½	6½

Note: the settlements in one pay round eg 1983-84 are mainly reflected in earnings growth in the next financial year eg 1984-85.

Financial surpluses and deficits

The pattern of financial surpluses and deficits in the economy, past and forecast, is shown in the following table:

£ billion, current prices

	Private sector			Public sector	Overseas sector (- denotes surplus on UK current account)
	persons	companies	Total		
1982	10	4	14	-7	-6
1983	6	7	13	-11	-3
1984	7	6	13	-10	-1
1985	7	3	10	-7	-3
1986	8	0	7	-7	0

The measurement of these balances, depending on uncertain estimates of income and expenditure, is subject to substantial uncertainty and revision. In the case of the company sector, for example, there are enormous measurement problems some of which imply that the figures for the financial surplus do not give a true picture.

Part of these shifts in surpluses and deficits reflect changes in in-inflation: the personal sector, a large holder of monetary assets, tends to save less when inflation is low (and when the real value of those assets is being eroded only slowly).

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Financial Forecast

US interest rates may edge up further in the second half of this year and perhaps a little further after the election. In 1985 and beyond (we assume) the growing likelihood of cuts in the fiscal deficit in the later 1980s leads to a levelling out and then a fall in nominal rates with rather more fall in real rates as inflation gradually picks up. But we expect real interest rates to remain high by postwar standards, not merely because of the lack of co-ordination of fiscal and monetary policies in the US but also as a continuing reaction to the low level for much of the 1970s of interest rates when they failed to give enough weight to inflation and to lending risks.

UK short-term interest rates are currently some 2 points below US rates; the key question is whether the further rise forecast for US rates will require either a rise in UK rates, or a fall in sterling. We have opted for little change in either in the short term, implying an increase in the differential between US and UK interest rates of about a further point. Even so, the resulting differential, of up to 3 points, is not large compared to the possible fall in the dollar/sterling rate nor to the differential between dollar rates and other currency rates (eg Germany, Japan).

Many UK commentators are expecting inflation rates of 6 per cent in 1985. At some stage, we assume, these expectations will come more into line with our forecast, allowing nominal interest rates, both short and long, to begin coming down again, consistently with meeting monetary targets.

UK interest rates might develop as follows:

	Short-term (3 month interbank)	Long term (20 year gilt)	Mortgage rate
1983 Q4	9½	10½	11¼
1984 (mid June)	9½	11	10¼
1984 Q4	9½	10½	11
1985 Q4	9	10	10¼
1986 Q4	8	9	10

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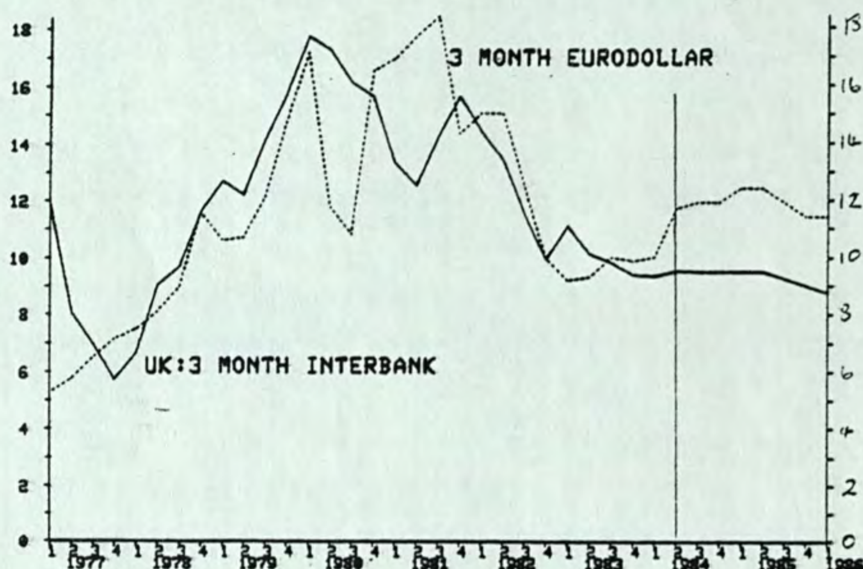
INTEREST RATES, PERCENT



Monetary aggregates

The main influences on MO are thought to be personal incomes, a proxy for transactions, the level of short-term interest rates and increasing use of bank accounts and, perhaps, credit cards etc. MO grew by 6 per cent at an annual rate over the 1983-84 target period. We assume little change in the trend rise of velocity over the forecast period, and with the growth of incomes and the average level of interest rates expected to be much the same this year as last, MO might again increase by 6 per cent in 1984-85, putting it at the middle of its target range. Thereafter, despite some fall in interest rates, MO growth might slow to 4-5 per cent, mainly due to a slowdown in the growth of personal income.

While MO is mainly held for transactions purposes, £M3 is much more a store of wealth and is therefore heavily influenced by the evolution of the financial wealth of the private sector. A smaller private sector financial surplus and slower growth of bank credit lead, in the forecast, to a slower rate of increase in gross financial wealth this year compared with last. This is the main reason we see some fall in the growth of £M3, from about $9\frac{1}{2}$ per cent in the last target period to 8 per cent in 1984-85. The

growth of wealth is expected to level off somewhat thereafter, but £M3 may continue to slow down, to remain comfortably within its target range.

The £M3 forecast can also be presented in terms of the familiar counterparts analysis, as in the table below:

£ billions

	PSBR	Debt Sales	(of which gilts)	Bank Lending	External and Other Adjustments	£M3
1983-84	9.7	12.4	(9.8)	15.4	-4.5	8.2
1984-85	6.2	7.5	(5.1)	14.7	-5.0	8.4
1985-86	7.0	7.0	(4.2)	14.0	-6.2	7.8
1986-87	7.2	6.5	(4.0)	13.3	-6.4	7.6

The table shows that slower growth of £M3 may be consistent with a much lower rate of net gilts sales to the non-bank private sector in future than in the recent past even if the pace of bank lending slows only slightly. A major reason is the fall in the PSBR, a fall which contributes to the fall in the private sector financial surplus noted in the discussion of financial wealth although the capacity of the market to absorb gilt sales will be reduced a little by the programme of asset sales. This will also tend to reduce the volume of new issues.

The figures for gilts sales in the table understate the funding requirement however because they are net sales to the non-bank private sector only. A more complete picture is given below:

£ billion

	Net sales to: Non-bank private	Overseas	Banks	Redemptions	Gross Sales
1983-84	9.8	1.1	0.7	3.7	15.4
1984-85	5.1	0.9	0.4	4.2	10.6
1985-86	4.2	0.7	0.4	5.9	11.2
1986-87	4.0	0.7	0.4	8.7	13.8

The forecast implies very little net over-funding over the next few years. Further discussion of gilts sales, particularly in the context of the institutions' flow of funds, is contained in the separate report on the Financial Forecast.

PSL2 has been growing more quickly than £M3 since the middle of last year and ended 1983-84 well above the top of the target range. This is mainly because of relatively fast growth in building society deposits. This pattern of building societies gaining share at the expense of the banks is likely to continue over the forecast period, as the societies adjust their interest rates more rapidly to market conditions and continue to expand their range of services. Even so the rate of growth of building society inflows and PSL2 should slow down, in line with personal wealth and income.

All the monetary aggregates are forecast with a large margin of error, but the limited life for M2 makes it particularly difficult to handle. Most of M2 is held by the personal sector and so we forecast it from a detailed look at the personal flow of funds. This suggests that M2 might continue to grow at recent rates over the next year but then decelerate with personal sector disposable income. The forecast of M2 and the other monetary aggregates is summarised in the table and chart below:

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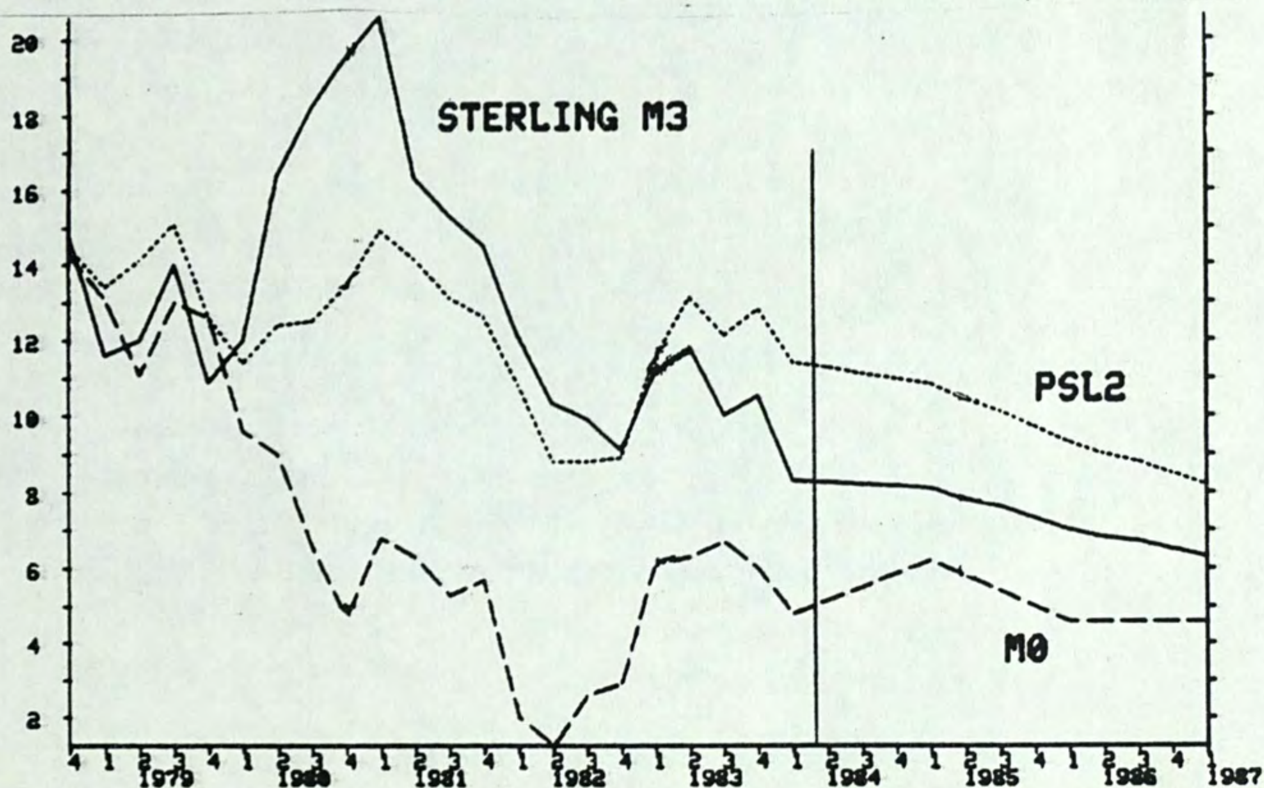
Per cent per annum

	MO		£M3		M1	M2**	PSL2
	Target	Outturn/ Forecast	Target Range	Outturn/ Forecast	Outturn/ Forecast		
<u>Target Periods</u>							
1982-83	-	$4\frac{1}{2}$	8-12	11*	$12\frac{1}{2}$	$9\frac{1}{2}$	$11\frac{1}{2}$
1983-84	-	6	7-11	$9\frac{1}{2}$*	14	$10\frac{1}{2}$	13
1984-85	4-8	6	6-10	8	$11\frac{1}{2}$	$9\frac{1}{2}$	11
1985-86	3-7	$4\frac{1}{2}$	5-9	7	9	8	$9\frac{1}{2}$
1986-87	2-6	$4\frac{1}{2}$	4-8	$6\frac{1}{2}$	$8\frac{1}{2}$	$6\frac{1}{2}$	8

*including public sector deposits

**April-April

MONETARY AGGREGATES PERCENTAGE CHANGE ON YEAR EARLIER



ANNEX: COMPARISON OF FORECASTS

Treasury Forecasts

1. Table A compares the current Treasury forecast with the last three budget forecasts and the autumn statement published in November.

2. The outlook for GNP growth this year is fractionally lower than in the budget forecast as the effect of the assumption concerning the miners' strike outweighs an upward revision to estimated oil production. Next year's forecast, however is higher because of the recovery from the strike affected level. Foreign interest rates are now expected to be slightly higher this year and so the forecast exchange rate a little lower. RPI inflation is slightly higher.

Outside Forecasts

3. Table B compares the Treasury forecast with an average of outside forecasts. The estimate for GNP growth this year is almost identical to the average of a fairly wide range of outside forecasts but 1985 growth is distinctly higher. This is in part a result of a higher Treasury forecast of real personal disposable income because inflation in 1985 is lower than that in all outside forecasts while earnings are growing at much the same rate. The same feature is present in the 1984 projections but to a lesser extent. It probably stems from a combination of faster growth in productivity, a slower rise in profit margins and lower import prices.

4. The PSBR forecast for the current year is now somewhat lower than the average of other assessments but the difference is well within the margin of error.

TABLE A

COMPARISON OF TREASURY FORECASTS

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Money Supply £M3 (% Change on year earlier)					
1982 Q1	14.5 (15.5)	13.8	13.8	14.2	14.1
1983 Q1	11.1 (11.6)	9.7	10.2	11.0	11.0
1984 Q1	8.9 (9.2)	9.0	9.9	9.5	9.5
1985 Q1	7.0 (7.3)	8.8	9.2	9.2	8.1
1986 Q1		7.5	8.0	8.2	7.0
PSBR £ billion (% of money GDP)					
1981-82	10.6 (4.2)	8.7 (3.4)	8.8 (3.4)	8.8 (3.4)	8.6 (3.4)
1982-83	9.5 (3.4)	7.5 (2.7)	9.2 (3.3)	9.2 (3.3)	8.9 (3.1)
1983-84	8.4 (2.8)	8.2 (2.8)	10.2 (3.4)	10.0 (3.3)	9.7 (3.2)
1984-85	6.7 (2.0)	8.0 (2.5)	8.1 (2.5)	7.2 (2.2)	6.2 (1.9)
1986-86	7.3 (2.0)	7.0 (2.0)	7.0 (2.0)	7.0 (2.0)	7.0 (2.0)
Fiscal Adjustments (£ billion)*					
1982-82	-	-	-	-	-
1982-83	-	-	-	-	-
1983-84	-0.3	-	-	-	-
1984-85	-2.1	-0.4	0.5	-	-
1985-86	-	- 3.8	-3.8	-1.9	-0.8
Nominal GDP (mp) (% Change on year earlier)					
1981	10.1	9.6	9.7	9.9	9.9
1982	10.6	8.8	9.3	9.5	9.5
1983	9.2	7.5	8.4	8.6	8.6
1984	9.9	8.6	8.0	8.1	7.3
1985	9.0	7.9	7.6	6.9	7.7
RPI (% Change on year earlier)					
1981 Q4	11.9	11.9	11.9	11.9	11.9
1982 Q4	9.0	6.2	6.2	6.2	6.2
1983 Q4	7.1	5.8	5.2	5.0	5.0
1984 Q4	6.0	5.4	4.2	4.3	4.5
1985 Q4	6.1	5.2	4.6	4	4.3

* A negative sign indicates a reduction in taxation

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Labour Cost Competitiveness					
(Ratio of UK to competitors costs 1975 = 100) **					
1981 Q4	139.3	131.4	102.4	102.4	100.5
1982 Q4	136.2	132.2	98.5	102.9	99.5
1983 Q4	130.3	121.0	91.0	98.5	95.2
1984 Q4	129.8	121.0	90.5	98.2	93.9
1985 Q4	129.1	118.6	92.1	97.1	95.4
Current Balance (£ billion)					
1981	8.3	6.0	6.6	7.3	7.3
1982	4.2	4.0	5.4	5.5	5.8
1983	2.9	1.5	0.6	2.1	2.9
1984	3.3	1.5	0.1	2.2	1.3
1985	3.3	-0.6	1.1	0.7	2.5
Manufacturing Output=					
(% Change on year earlier)					
1981	-6.4	-6.4	-6.6	-6.4	-6.4
1982	3.2	-0.6	0.4	0.1	0.1
1983	2.2	1.8	1.3	1.5	1.9
1984	1.9	2.4	2.8	3.6	3.0
1985	1.3	1.9	1.4	2.1	1.7
GDP Volume (fc)					
(% Change on year earlier)					
1981	-2.0	-2.5	-1.6	-1.4	-1.4
1982	1.4	0.7	1.8	2.0	2.0
1983	2.4	2.0	2.8	2.8	3.0
1984	2.8	2.7	2.9	3.1	2.9
1985	2.2	2.4	2.8	2.5	2.9

** FOR COLS 3-5 1980 = 100

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Interest Rates %					
Short Term					
1981-82	14.2	14.2	14.2	14.2	14.2
1982-83	13.5	11.3	11.5	11.5	11.5
1983-84	11.9	9.6	9.6	9.7	9.7
1984-85	10.2	7.8	8.3	8.7	9.5
1985-86	8.9	7.4	8.1	7.8	9.1
World Trade in Manufactures UK Weighted					
1981	4.1	3.3	3.3	3.3	3.0
1982	4.0	-3.3	-3.1	-2.8	-1.8
1983	4.6	1.0	-0.7	1.3	-0.2
1984	5.5	6.6	5.3	5.1	5.4
1985	4.5	5.7	6.3	4.5	5.6
UK Exports of Goods and Services (% Change on year earlier)					
1981	-1.5	-2.3	-2.0	-2.0	-2.0
1982	3.3	0.7	1.4	1.5	1.2
1983	3.7	0.9	0.6	0.6	0.8
1984	4.4	5.0	4.0	5.0	6.3
1985	4.0	4.9	3.9	3.9	3.7
Average Earnings (private, not cyclically adjusted - % Change on year earlier)					
1981 Q3	13.2	10.0	9.4	10.0	10.9
1982 Q3	10.1	10.0	10.1	9.8	9.9
1983 Q3	8.3	7.3	8.4	8.3	7.9
1984 Q3	7.5	7.0	7.3	7.5	7.3
1985 Q3	6.9	6.5	6.4	7.3	7.5

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Effective Exchange Rates					
1975 = 100					
1981	94.9	94.9	94.9	94.9	94.9
1982	88.5	90.6	90.6	90.6	90.6
1983	84.6	80.5	83.4	83.3	83.3
1984	81.9	81.8	83.6	83.2	80.1
1985	81.4	80.8	83.0	83.5	80.7
Unemployment					
(UK sa excl school leavers - millions, new definition)					
1981 Q4	2.6	2.6	2.6	2.6	2.6
1982 Q4	2.8	2.9	2.9	2.9	2.9
1983 Q4	2.8	2.9	2.9	2.9	2.9
1984 Q4	2.8	3.0	2.9	3.0	3.1
1985 Q4	2.8	3.1	2.8	3.0	3.1
I & C Companies' Financial Surplus/ Deficit, £ billion					
1981	1.4	2.0	2.7	2.7	3.3
1982	0.2	1.1	2.3	2.5	3.6
1983	-1.8	0.7	4.8	6.4	6.7
1984	-0.9	2.3	4.6	5.1	5.4
1985	-0.4	1.8	5.0	2.0	1.9

TABLE B COMPARISON WITH OUTSIDE FORECASTS

	TREASURY June 1984	OUTSIDE FORECASTS Consensus	Range	
£M3 % change in year				
1984-5	7.8	8.3	7.1(S&C)	9.9(P&D)
1985-6	8.1	8.2	7.0(NIESR)	10.6(Henley)
£Mo % change in year				
1984-85	6.2	5.4	5.3(S&C)	5.7(P&D)
1985-86	4.6	6.4		
PSBR £ bn				
1984-5	6.2	7.6	6.9(S&C)	9.7(NIESR)
1985-6	7.0	7.4	5.4(LBS)	9.2(NIESR)
Exchange rate 1975 = 100				
1984 Q4	79.6	81.8	81.0(S&C)	82.0
1985 Q4	81.0	80.7	77.9(NIESR)	84.0(LBS)
Current account £ bn				
1984	1.3	1.2	0(LBS)	2.7(Liverpool)
1985	2.5	1.3	-0.3(NIESR)	3.0(Liverpool)
Average earnings % change on year earlier				
1984	7.2	7.4	6.9(Cambridge)	7.2(P&D)
1985	7.5	7.5	6.2(NIESR)	8.0(Henley)
RPI(CED*) % change on year earlier				
1984 Q4	4.5	5.2(5.6)	4 3/4(CBI)	6.0(NIESR)
1985 Q4	4.3	5.9(5.6)	5½ (CBI)	6.0(NIESR)

* LBS

RPDI % change on year earlier				
1984	3.2	2.5	1.3(LBS)	3.1(CBI)
1985	3.1	1.9	1.3(LBS)	2.5(P&D)
Import volume: goods & services % change				
1984	7.6	6.3	4.5(CBI)	9.0(P&D)
1985	3.5	3.1	1.4(P&D)	4.5(CBI)
Export volume: goods & services % change				
1984	6.3	6.0	3.6(CBI)	7.8(S&C)
1985	3.7	3.5	2.7(S&C)	4.4(Henley)
GDP volume % change				
1984	2.9	2.8	1.9(NIESR)	3.4(P&D)
1985	2.9	2.1	1.4(Cambridge)	2.4(S&C, P&D)
Unemployment (millions)				
1984 Q4	3.07	2.98	2.91(LBS)	3.0(NIESR, Henley)
1985 Q4	3.06	2.98	2.81(LBS)	3.1(S&C)

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10 DOWNING STREET

From the Private Secretary 21 June 1984

NATIONAL SAVINGS

The Prime Minister saw your letter to me of 19 June and was content with the adjustments which are proposed in the terms of some of the National Savings instruments.

Andrew Turnbull

Adrian Ellis, Esq.,
H.M. Treasury.

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Prime Minister
Treasury are proposing no major change on the main NS instruments, but a few modifications. Content?
AT 19/6

Treasury Chambers, Parliament Street, SWIP 3AG

Andrew Turnbull Esq
Prime Minister's Office
10 Downing Street
LONDON
SW1

19 June 1984

Dear Andrew,

NATIONAL SAVINGS

National Savings inflows in April and May were well below the level achieved earlier in the year, and if the current rate were to continue, we could end up £½ billion or so short on the £3 billion target for the year.

Officials have considered whether, in the circumstances, National Savings rates should be increased in order to improve the inflow. Their conclusion, which the Economic Secretary endorses, is that it would be unwise to do so just now. Any significant move now would provide quite the wrong signals to the markets and it would almost certainly provoke the building societies into raising their rates. It seems quite likely that the societies will have to increase their rates before the end of summer - and probably before if base rates were to rise further. If and when the societies move, that will be the same for raising National Savings interest rates.

There are, however, some minor measures which the Economic Secretary believes would be worthwhile introducing to improve the attractiveness of some of the National Savings products, but which fall well short of an interest rate package. These measures are:

i) Yearly Plan: a new savings scheme already announced involving the purchase of a National Savings Certificate by regular savings over a year, would be launched on 2 July.

This replaces SAYE

ii) Index-Linked: the present 2.4 per cent supplement on index-linked National Savings becomes available in November and as happened last year it is proposed to make a statement of the Government's intention beyond then well in advance. Withdrawals from the index-linked certificates continue at a rather high level and this year's supplement offers a poor real rate return compared with other personal savings instruments. Against that background, a higher supplement is needed and it is intended to make it 3 per cent for the 12 months from November 1984. In addition, in future there will be a 4 per cent bonus 5 years after maturity, just as there is a 4 per cent bonus at maturity. In order to give a longer term assurance, it will also be announced that it is the Government's intention to give supplements on index-linked savings for at least a further 3 years (though the future rates of supplement will not be specified).

iii) Income Bond: it has been particularly hard hit by the last reduction of interest rates, and net sales have reduced by half since March. The Bond will be made more attractive by easing the conditions of withdrawal which are definitely out of line with competitors.

The intention is that these measures will be announced on Thursday 21 June.

Yours sincerely,

Adrian Ellis

A M ELLIS
Private Secretary

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PRIME MINISTER 29 May 1984

STATE OF THE ECONOMY

The United States of America

At the end of 1983, I wrote explaining why the dollar was not then falling as many predicted. The dollar has again powered ahead based on:

a. The higher interest rates caused by the monetary and deficit troubles.

b. A renewed reluctance by US banks to lend more money overseas to shore up the debtor nations.

c. The growing international tension, particularly in the Gulf, which makes international depositors more enthusiastic about placing money in the States than in less secure countries, or even in countries short of oil like Japan.

d. The industrial troubles in Germany and the UK.

Interest Rates

Both short- and long-term interest rates in the States have been rising sharply. Long bonds in the US now offer a yield

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of 13.4 per cent, compared with 10.7 per cent a year ago. Short rates (Primes) are now 12.5 per cent.

The combined public and private sector demand for credit is enormous compared with available US savings. The US can continue to run its large budget deficit only if it succeeds in deterring private sector borrowing by high interest rates and/or if it succeeds in attracting more savings, also by higher interest rates. The other possible course - that of printing the money - would work in the short-term, but is still an unattractive option to the Fed., who remain concerned about rekindling inflation.

The table below sets out the total US requirement for credit:

	1981	1982	1983	1984(est.)
	$bn	$bn	$bn	$bn
Total borrowing	490	480	618	710
Public Sector	155	275	300	290
Private Sector	335	205	318	420

In 1980 and 1981, US private savings were double and then treble the Federal deficit. They were equal to the deficit in 1983, and may be less than the deficit in 1985. Thus the only way of financing the growing demand of the private sector for credit, and of paying for the yawning gap in the balance of trade, is with money from overseas. This assumes that more rapid inflation and money growth are ruled out.

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Bond and Equity Markets

Both the bond and the equity markets are showing the tensions early. The equity market keeps on hitting new lows this year, and even the satisfactory profits figures and good real growth in the economy cannot produce any smiles on the face of the Wall Street investor. We are living through that period in the US when industrialists and some outside commentators express surprise at how well profits and activity are doing, and ask why it is that the stock market is so perverse. This is the usual position towards the top of an economic cycle, where the pressures on credit markets are already severe, throttling off the money for securities markets, and sending them into a spin with the higher interest rates that result. Similarly, the bond market is showing the paranoia you would expect when asked to finance too large a Government deficit for the amount of cash available.

What Happens Next?

In the short-term, there is an unholy tension between the fears generated in the wake of the Continental Illinois collapse on the one hand, and the need for higher interest rates to restrain credit demand on the other. The US economy is a particularly cumbersome one to manage when trying to cut private sector borrowing, because most interest on loans is tax-deductible. The quickest way to

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reduce the budget deficit and to cut credit demands, would be to cancel the tax-deductibility of all interest charges: this could, however, bring a number of the borrowers into severe difficulties, and would therefore curb credit in a painful way.

This tension is likely to be resolved by:

1. a trend towards higher interest rates unless and until the credit demands are abated; but
2. some temporary recourse to printing money (lower interest rates and more inflation) whenever a major bank seems to be in difficulties.

The only long-term way out is by cutting the budget deficit. Perhaps the events of the last few weeks have brought nearer the point when the President feels he can present proposals that come to grips with the deficit this year rather than at some future date. Once he did so, the bond market in particular would leap upwards and interest rates could then start to fall.

The banking tensions are serious. The LDCs do need lower interest rates in order to preserve the fig leaf of honesty about repayment of capital, and even about the payment of interest. On the other hand, as the risks of the international banking system are perceived to grow, and as the countries themselves start discussing the possibility of

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non-payment, the risk premium in rates charged to LDCs will tend to rise. There is a lot to be said for Alan Walters' suggestion that a market should be created in LDC debt so that banks can (a) quantify their losses; (b) sell on some of the worst risks if they are over-extended, in order to gain liquidity which they desperately need.

It should be remembered that banks are always technically bankrupt, as they lend long and borrow short to a greater or lesser extent. A bank collapses normally not because it is insolvent, but because it is illiquid. As soon as depositors lose confidence, a run develops and the bank runs out of till money. The FDIC reassured the system by underwriting Continental Illinois, and by pledging further support. US markets will now believe that if a bank is large enough, and its loan book bad enough, the FDIC will stand behind it; and this goes a long way to averting the fear of a financial Armageddon.

United Kingdom

The United Kingdom economy, which has been recovering nicely for 3 years, now has to weather these major international shocks. Sterling has suffered along with other major currencies against the rise of the dollar. Interest rates here have been dragged up. The only way to prevent our recovery being more badly affected, and our interest rates being forced up too far, is by the continuation of sound policies - particularly on public borrowing. Any country

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which is running too large a government deficit against the background of US monetary turbulence is running great risks. Any country which itself develops some of the bad American habits could find the backwash from the US banking crisis that much more difficult.

Our problem is going to be a political one. The result of American action, and more especially of American inaction over the budget deficit, is going to be a slowing of US economic growth, which in its turn will slow down the recovery in the rest of the world. As our unemployment hasn't even begun to fall yet, it is difficult to explain that the US recovery is under pressure and that we have to persevere with a fairly restrictive stance so that the international turbulence does not worsen our position. The good news is that the combination of banking crisis and plunging markets in the States will bring home, in a visible way, damage caused and perpetrated by the high American deficits and high American interest rates.

The Oil Crisis

Oil and financial markets have been relatively sanguine so far about the condition in the Gulf. It may be wrong to be too relaxed. Some 11 million barrels of oil are produced by the Gulf States in normal conditions. Half of this could be replaced quite easily by increases in production elsewhere or sent by different routes. Whilst it is true that the

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Saudis have large stocks, and that international stocks are higher than they were in 1974 and 1979, the amount of oil which could be withdrawn from the system is actually larger this time than the amount withdrawn at the time of the Iranian crisis in 1979.

If the Gulf is made dangerous for shipping, we must assume that the oil price will rise, and could rise quite dramatically. Even with Saudi-American co-operation in providing air cover for tanker convoys, oil movements in the Gulf could be reduced substantially. Iraq is likely to carry on with its attacks on ships bound towards Kharg Island.

The miners' strike will be more difficult to continue if oil markets take off. It would be important to have bought as much fuel oil forward as possible to secure the supplies needed to continue with maximum oil burn, which is a vital part of our endurance. Our own position as a net exporter of oil gives us some advantages as, in extremis, the Government does have powers to organise contracts to help our own refineries. In the meantime, the policy of wait-and-see and keep the markets calm may break down: the IEA proposals should then be implemented swiftly.

Conclusions

1. The US over-borrowing and financial tensions are coming to a

head. In the short-term, pledges to bail out the banks might mean some monetary easing, and therefore more inflation. Until the budget deficit is cut, however, we should expect the trend in US interest rates to be upwards, and for growth to start to slow down by next year.

2. The best stance for the UK to follow remains that of caution. Against a background of an international banking crisis, and a nascent oil crisis, any country which is borrowing too much, or has an unsound balance of payments, is that much more vulnerable.

3. The Economic Summit will have to say something more about the international debt crisis. Could it not reconsider the marketable debt solution, so that we can quantify the damage and start talking about the truth of the position rather than papering over the cracks in the major international banks? Marketable debt will erase the worst fears about bank insolvency and enable banks to sell debt to raise cash when they need it.

4. The safety of shipping in the Gulf cannot be guaranteed. Shipping is already slowing, and if this continues for any length of time, we must assume that the oil price will rise, and could rise sharply. Even with positive Saudi action, oil shipments could decline. This will help sterling, and will help UK Government revenues, but it will hinder recovery world-wide.

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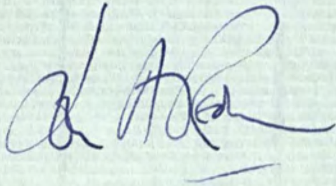
5. We should make sure our contingency plans concerning oil for power stations and refineries are in good shape.



JOHN REDWOOD

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SECRET

24 May 1984

MR TURNBULL

FUNDING MEETING

I attended the Funding Meeting today. As we feared last month, the position has deteriorated in the markets. The combined effect of higher US interest rates, the flight into the dollar caused by those higher rates and the Iran/Iraq war, the impact of the UK miners' strike, the surge in the UK PSBR, and the reverberations of the Continental Illinois collapse, have all led to torrid conditions in the gilt market.

In banking May, gross official gilt sales fell to £520 million - they need to be around £1.25 billion.

The meeting was somewhat fatalistic in its response to these difficulties. It was agreed that:

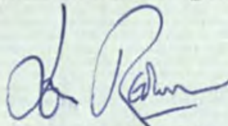
1. There would be no immediate change in National Savings interest rates, but if the building societies upped theirs, National Savings rates would then be reviewed.

2. I persuaded the Treasury and National Savings people to reconsider the question of new index-linked issues, coupled with a review of the level of bonus needed this autumn to retain most of the money currently invested in National Savings indexed certificates. Without an adequate bonus, there will be a major outflow.

3. In the gilt market, there is a reasonable range of stock available, and this would be sold as and when possible. The Bank warned that another 0.5 per cent increase in short-term rates might be needed, given the international background and the miners' strike.

4. There would be no precipitate action in the gilt market, as this is a 5-week month. The Economic Secretary would review the situation with the Bank after 2 weeks had elapsed.

Market sentiment is not going to be turned by any action of the Bank at the moment. The best that can be done is to sell as much National Savings, gilts and equity assets as possible, and hope that some of the bad news is replaced in the market psyche soon.



JOHN REDWOOD

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PRIME MINISTER

Funding Strategy

Alan Walters has suggested that the Treasury undertake a review of strategy and tactics for funding - see his minute attached. I have spoken to both Peter Middleton and John Redwood (who now represents No.10 at the Treasury/Bank funding meetings). They both feel that what Alan is recommending is already going on. The Treasury are looking at a number of issues relating to funding - in what circumstances, if any, it is appropriate to sell long dated gilts; whether there should be an effort to convert outstanding long gilts into indexed gilts; what are the implications for the way in which gilts are marketed of the changes now taking place in the stock market. When auctions of gilts were considered, a major objection was always that there were not sufficient, adequately capitalized, market makers to cope with the swings in price which auctions would produce, but this lack is now being made good as the jobbers join forces with larger institutions.

Alan's minute also gives the impression that the method of selling gilts has survived unchanged from the 1960s and 1970s. This does not give credit for the substantial changes in instruments and methods of sale which have taken place since 1979 and which have improved our funding effort:

- part payment of gilts

- minimum price tenders as opposed to fixed price offers

- IGs, sold by auction

- tranchettes as opposed to full sized taps

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- convertibles

- greater willingness to adjust the price of tap stocks

- a facility to borrow stock from the National Debt Commissioners to meet demand for stock not held by the Bank

- greater emphasis on short dated stocks

- greater emphasis on National Savings and asset sales as alternatives to gilts

In these circumstances I do not think we need to minute the Treasury to put Alan's suggestions to them. John Redwood and I will follow progress on the Treasury work and report from time to time.

AT

Andrew Turnbull

18 May 1984

E.R.

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cc Mr Willetts

PRIME MINISTER

FUNDING STRATEGY

I expect that real interest rates will continue to be, in historical terms, high for the next two or three years. We can do little about that. The world capital market will be dominated by the extraordinary United States demand for credit. I see little sign of that waning over the next two or three years.

Our basic funding strategy and tactics were developed over the late Sixties and Seventies. This was a period when we had negative real interest rates. Thus the Bank developed the "Duke of York" technique. It put interest rates up sharply and suddenly, and thereafter allowed a gentle fall in interest rates over the next year. This gave a sure-fire capital gain to the bond holder who bought when the price was low, provided he got out before the next interest rate rise.

It was argued that a sure-fire capital gain was the only way we could sell gilts. The active traders made capital gains and the long term holders, or those who were not so fleet of foot, lost out. The prospective capital gain, however, always kept the active traders punting.

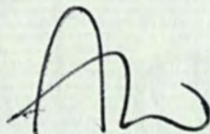
Now, and indeed over the last two years, the situation has changed dramatically. Today the real rate of return on gilts is about 5%, before tax. No longer is it negative, nor is it likely to be negative over the next few years and, as I've argued above, it is likely to be much higher than the historical normal rate of about 2½% or 3½%.

We have, therefore no need to consider "Duke of York" tactics. They are clearly inappropriate when the holder of gilts is getting 5% real. In principle this enables the Government to withdraw further from an active policy in the short term credit markets.

I suggested to the Treasury that they should consider the need for a new strategy and tactics for funding. It is a large issue which spills over into virtually all aspects of financial policy.

I would like to participate at some stage. However, in view of our discussion yesterday about the interest rate policy, I thought I ought to tell you of my general thoughts and of my suggestions to the Treasury. It is likely that the Chancellor will talk to you about this during one of your normal meetings.

I will talk to Alan next time he is over. Please allocate enough time. MT



ALAN WALTERS
9 May 1984

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Lord Hailsham of
St Marylebone, CH, FRS, DCL
Lord Chancellor
Lord Chancellor's Department
House of Lords
LONDON
SW1A OPW

27 March 1984

Dear Quintin

MEDIUM TERM FINANCIAL STRATEGY

Thank you for your letter of 13 February in which you expressed your concern about the effect upon your Department of limiting expenditure in 1987-88 and 1988-89 to the levels agreed for 1986-87.

I have, of course, taken note of your misgivings about the future and I do not discount them. But I still hope it may be possible to find ways of absorbing extra workloads and exerting greater discipline on programme spending. As you will have seen, the Green Paper - "The Next Ten Years: Public Expenditure and Taxation into the 1990s" - shows that there will continue to be many pressures for higher spending, and that we need to contain these if we are to bring the burden of taxation back to tolerable levels.

I am copying this letter to the Prime Minister, Nigel Lawson and Leon Brittan.

Yours ever
Peter

PETER REES

ECON POL: Strategy

Pt 26

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Fuk

Rev)

10 DOWNING STREET

From the Private Secretary

16 March, 1984

NATIONAL SAVINGS RATES

The Prime Minister has seen your letter to me of 15 March reporting that the Chancellor intended to announce on 19 March the withdrawal of the 26th issue National Savings Certificates and their replacement by a new 27th issue; and the announcement of new rates on other National Savings instruments. She is content with these proposals.

(A. Turnbull)

J.O. Kerr, Esq.,
H.M. Treasury

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Prime Minister (1)
Agree X?
AT 15/3

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

Yes MT

15 March 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

The building societies meet tomorrow morning and, as you know, are expected to announce a reduction in both their mortgage and deposit rates. We shall then need to announce lower rates for National Savings. The building societies would complain if the National Savings rates did not move down quickly: more important, we could find ourselves taking funds at excessive cost (and perhaps at an excessive rate in relation to the £3 billion National Savings target.)

X The Chancellor intends to announce on 19 March the withdrawal of the 26th issue National Savings Certificates, and their replacement by a new 27th issue. The announcement would also cover new rates on the Investment Account, the Income Bond and the Deposit Bond.

Details of all the new rates cannot be settled until we know the building societies' decisions, not only on their ordinary share rates but also on the premium rates, which have been responsible for much of their heavy inflow in recent months. But the Chancellor's general aim will be to reduce the rates on all four instruments so as to maintain their relative competitiveness with the building societies, and possibly to go slightly further on the Investment Account rate. This should be consistent with a future inflow matching the £3 billion target.

The Prime Minister has on previous occasions asked to be consulted about such changes, and the Chancellor would be grateful if you could confirm that she would be content with this general approach.

Yours ever,

J O Kerr

J O KERR
Principal Private Secretary

PART 25 ends:-

LBS ECONOMIC OUTLOOK 83-87

PART 26 begins:-

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