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ECONOMIC AFFAIRS - THE CHANCELLOR'S STATEMENT

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

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The Chancellor's Statement

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

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

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

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

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

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

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

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

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

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

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

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

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

3. Monetary Targets

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

4. Minimum Lending Rate

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

5. Methods of controlling the money supply

The Chancellor said:-

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

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

6. Special Employment Measures

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

7. Public expenditure and the PSBR

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

8. Public Expenditure Cuts

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

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

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

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

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

9. Revenue changes

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

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

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

10. Nationalised Industries

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

Economic Forecast: an extract is attached below.

11. SOCIAL SERVICES AND THE CONSERVATIVE GOVERNMENT

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

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

The Elderly

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

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

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

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

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

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

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

The disabled

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

again.

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

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

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

One-Parent Families

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

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

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

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

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

National Health Service

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

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

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

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* based on 95% return

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

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

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

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

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

Personal Social Services/Volunteers

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

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

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

Public Expenditure Cuts

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

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

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

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

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

12. ECONOMIC PROSPECTS

Introduction

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

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

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

Inflation

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

World economy and UK trade

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

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

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

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

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

Domestic demand and activity

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

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

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

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

The Public Sector Borrowing Requirement

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

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

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

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

Margins of error

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

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