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Prime Minister - To note

PRIME MINISTER

(I suggest you read the summary at Flag A)

I think you will want to see the latest Treasury forecast which has recently been completed. The forecast uses post-Budget policy assumptions, though the package incorporated is now somewhat out-of-date. In particular, we now expect a rather smaller impact on the RPI, which is now likely to show a rise of 17 per cent rather than $17\frac{3}{4}$ per cent for the fourth quarter of 1979. (In most other respects the forecast will not be materially affected.) You should know that the usual tables in the FSBR will go on to show the prospect of a substantial fall in the year-on-year inflation rate by the third quarter of 1980.

2. The prospect is obviously an uncomfortable one in many respects. As I have observed in my separate note on the Budget package, I shall ensure that the final package enables us to display a PSBR forecast for 1979-80 of £$8\frac{1}{4}$ billion; i.e. below Denis Healey's target. But the consequence is inevitably a discouraging one in the short-term both for output (and therefore employment) as well as for prices. There are, however, a number of considerations which should help to de-fuse the impact of these figures. Far and away the most important is the fact that any Budget - from any Government - at this time would have had to be "deflationary". Certainly Denis Healey will not be able to deny that to achieve his own stated PSBR target of £$8\frac{1}{2}$ billion (let alone to increase tax allowances beyond the provisions in the April Finance Act) he would equally have had to introduce a contractionary Budget.

3. We must accept that the increases in indirect taxes - and to a lesser extent some of the public expenditure measures - have an

CHANCELLOR OF THE EXCHEQUER

adverse impact on prices. We now put this at about $3\frac{3}{4}$ per cent. By the middle of next year there may be about another 0.3 per cent from the effects of higher nationalised industry prices and the increase in prescription charges. (I do not include the nationalised industry price increases required which are happening anyway, simply to meet the previous Government's cash limits.) The increase arising from the Budget is, of course, only a comparatively small part of what is happening. There is not much we can do immediately about the underlying $12\frac{1}{2}$ per cent. It is fair to say that most of this is the inevitable consequence of the failure of the last Government's policies, of unavoidable developments in the world in general (especially oil prices) and of several specific decisions on which we can defend our policy on merit. Our general theme must remain that firm monetary and fiscal policy is the surest way to get inflation down; but that there is bound to be an uncomfortable interval before this policy achieves results.

The Chancellor will let us know his conclusion on Monday
TL

4. On output, the gloomy prospect for the immediate future is an inevitable implication of our pre-lunch conversation and of the policies which we believe should set the economy on the right path for the longer term. The net effect of these measures according to normal national income forecasting procedures (as used in the Treasury and by most other practitioners) is bound to be deflationary in the short-term. While we appreciate that conventional forecasting methods fail to pick up many of the beneficial effects of these policies it is clear that these effects take time; particularly insofar as improvement in the underlying supply side performance of the economy is concerned. I have ensured that the forecasts make some allowance for the favourable effects of our policies on consumer and business confidence. We can also argue that by making a substantial part of our package consist of asset disposals (£1.2 billion this year) - measures

which the Opposition would reject on doctrinal grounds - we are helping to achieve a low PSBR at much less cost to the economy.

G.H.

(G.H.)

R/1 June 1979

BUDGET - SECRET

cc Chief Secretary
Financial Secretary
Minister of State(L)
Minister of State(C)
PCC Members
MEG Members
Mr Ridley
Miss Brown
Mr Evans
Mrs Lomax
Mr Riley
Mr Sedgwick

CHANCELLOR OF THE EXCHEQUER

ECONOMIC PROSPECTS TO 1980-81

--- I attach the revised Treasury National Income Forecast, of which you will have seen a preview on Tuesday.

2 Further to my comments on the preview we now calculate that if the Budget assumptions used for the forecast were changed to those of the higher indirect tax version of the "second sighting shot" the 1979-80 PSBR would come down by nearly £200 million to £8¼ billion. If the further squeeze on cash limits consequent on the higher price forecast is fully reflected in policy, this could bring the PSBR figure down to a little above £8 billion. This of course is the most stringent interpretation possible. It assumes, for example, that the most RPI-expensive tax option is adopted, that all of the £1 billion of asset disposals score for PSBR purposes and that the planned expenditure cuts and reduced contingency reserve are held without any concessions.

JRS

J R SHEPHERD
24 May 1979

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ECONOMIC PROSPECTS TO 1980-81

May 1979 Forecast

Introduction and Summary

This forecast is constructed on a provisional post-Budget basis. The Budget assumption was based on the package available to us on May 17th. Adjustments to the forecast to reflect a more recent Budget package are being made separately. The policy assumptions are listed fully in paragraphs 5-11. The expenditure package assumed was somewhat arbitrary and is not therefore described in great detail. Apart from the Budget itself the general approach in determining the assumptions was to take account of firm decisions by the new Government (eg those on armed forces pay and on the Price Commission) but not to attempt to predict specific future decisions. It was, however, assumed that there would be further expenditure cuts in 1980-81 sufficient to keep the planned level of expenditure at the reduced 1979-80 figure. No further tax changes (apart from indexation for inflation) were assumed for 1980-81.

2 Other key policy assumptions include the growth of £M3 in 1979-80 towards the centre of a 7-11% target range. In 1980-81 monetary policy remains restrictive in that it does not accommodate the rise in money incomes, but in the light of the large PSBR which is indicated in the forecast it was not thought appropriate to try to keep the growth of £M3 to around 9% or less by means of sharply rising interest rates. The exchange rate is assumed to be determined by market forces, with no net intervention by the authorities. Debt repayment continues and a package of exchange controls involving outflows of around £1 billion is included. Pay was projected on the basis of the going rate in the present pay round, guesses at the outcome of public sector comparability agreements and very tentative estimates of an underlying relationship between pay, prices, taxation and the pressure of demand.

3 A numerical summary of the forecast is set out in the table on page 4. None of these numbers should be taken too literally. Margins of error are always large and there are a number of factors - notably the scale of the Budget measures and the associated rise in consumer prices, and the exceptionally unfavourable level of international competitiveness - which add to the uncertainties on this occasion. Paragraph 33-37 attempt some quantification of the margins of error. It is helpful to think of the forecast as amounting to a limited number of propositions, containing only a minimum of numbers, which can be put forward with a reasonable degree of confidence. Much more detailed arithmetic is necessary in compiling the forecasts and some of the detail is useful for specific purposes. But for most general uses the detailed tables annexed to this note should not be taken as indicating more than these general propositions imply. Thus the forecast indicates,

(1) The UK economy is likely to move further into recession. The volume of GDP is unlikely to rise much and is more likely to fall from the level reached in the second half of 1978. Manufacturing output may fall significantly.

(2) Unemployment is expected to increase.

(3) Earnings increases for the economy as a whole may remain at around 14% in the current pay round, perhaps accelerating slightly in 1979/80 when comparability agreements will mean higher increases for the public services.

(4) With oil prices rising sharply the exchange rate beginning to turn down and some domestic factors (eg rates) adding to inflation, retail price inflation well into double figures could be expected this year even in the absence of Budget measures. Allowing for the Budget an RPI increase of approaching 18% is foreseen between the beginning and end of this year. Next year the increase will fall back (on our policy assumptions), perhaps to 13% or a little over.

(5) The PSBR forecast for 1979-80 of some £8½ billion is still rather above the Government's objective. Interest rates rise above their present levels in order to keep the growth of £M3 towards the centre of the 7-11% range. In 1980-81, in the absence of fiscal

action going beyond the further expenditure cuts assumed, the PSBR could rise by more than in proportion to nominal GDP (perhaps to a level of about £10 billion) and a tight monetary target could be very difficult to achieve without substantial rises in interest rates.

(6) The depressed economy and the continued build-up of oil production should keep the current account in balance or modest surplus. But (excluding oil) the volume balance of exports compared with imports will probably worsen further this year with no prospect of recovery in 1980.

(7) Though the timing of exchange rate movements is very difficult to foresee, the effective rate is likely to fall back from its current particularly high level over the full period of the forecast. The rate could hold fairly firm during 1979 but show a more marked fall next year as, among other things, the unsatisfactory fiscal and monetary background for 1980-81 begins to emerge. Despite a fall in the exchange rate, cost and price competitiveness are likely to remain unfavourable by the standards of the recent past, contributing to the difficulties of manufacturing industry.

(8) Poor international competitiveness, depressed activity and high interest rates are expected to worsen the financial position of industrial companies. No major liquidity crisis is foreseen, but profitability may be very low and the prospect must be a discouraging one for investment and stockbuilding despite possibly favourable effects of Government policy on longer term expectations.

4 The remainder of this paper lists the policy assumptions in more detail, explains some of the key forecasting judgments involved and indicates both the particular uncertainties and the general margins of error attaching to forecasts of this kind. The attached tables provide a selection of the more detailed numerical work incorporated in the forecast. The financial forecasts are being covered in a separate note.

May assessment: summary of forecast

PERCENTAGE CHANGES ON A YEAR EARLIER

Gross Domestic Product (volume)

2nd half 1978	3.0
2nd half 1979	-0.4
1st half 1980	-1.0
2nd half 1980	-0.8

Manufacturing Production

2nd half 1978	1.1
2nd half 1979	-1.1
1st half 1980	-1.8
2nd half 1980	-2.0

Average earnings

3rd quarter 1978	14.2
3rd quarter 1979	14.1
3rd quarter 1980	15.8

Retail price index

4th quarter 1978	8.1
4th quarter 1979	17.8
2nd quarter 1980	18.5
4th quarter 1980	13.3

LEVELS

Current balance (£ billion)

1978	0.3
1979	0.4
1980	0.1

PSBR (£ billion)

1978-79 9.3 (5.6% of market price GDP)
1979-80 8.4 (4.4% of market price GDP)
1980-81 10.0 (4.6% of market price GDP)

Effective exchange rate (December 1971 = 100)

4th quarter 1978	62.7
4th quarter 1979	64.9
4th quarter 1980	61.9

Labour cost competitiveness: (increase implies worsening of competitiveness)

4th quarter 1978	93.6
4th quarter 1979	103.5
4th quarter 1980	105.1

Interest Rates	Short Rates	Long Rates	Mortgage Rate
Average 1978-79	$10\frac{3}{4}$	13	$9\frac{3}{4}$
Average 1979-80	$12\frac{1}{4}$	13	$11\frac{3}{4}$
Average 1980-81	$12\frac{3}{4}$	$14\frac{1}{2}$	$11\frac{3}{4}$

BUDGET- SECRET

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10 DOWNING STREET

From the Private Secretary 4 June 1979

The Prime Minister was grateful for the Chancellor's minute of 1 June in which he set out his main Budget proposals. This is to confirm that she is content with them.

The Prime Minister has also considered the Chancellor's minute of 1 June concerning VAT on petrol. She is content to accept the Chancellor's judgement on this matter, though she has noted that he intends to instruct officials to give it more detailed consideration after the Budget for possible action either next year or, if the energy supply situation should seriously deteriorate, later this year.

The Prime Minister was also grateful for the Chancellor's note, and the accompanying papers by officials, on the forecast.

T. P. LANKESTER

Tony Battishill, Esq.,
HM Treasury.

BUDGET - SECRET

(NB 2nd carbon shredded 4/6.)