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ECONOMIC PROSPECTS TO END- 1981

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

Summary

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

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

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

RECENT ECONOMIC DEVELOPMENTS

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

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

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

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

Percentage balances of ups and downs

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

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

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

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

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

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

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

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

ECONOMIC PROSPECTS

Introduction

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

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

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

Inflation

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

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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TABLE 1: ECONOMIC PROSPECTS TO END 1981

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

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

/ This margin applies to general government consumption only.

* This margin applies to private sector investment only.

TABLE 2

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

£ million at 1975 prices, seasonally adjusted

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

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

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