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H.M. Treasury,
Parliament Street,
London. S.W.1.

18 November 1979

Dear Tim,

The Chancellor of the Exchequer has asked me to let you have the enclosed draft of the forecast which he proposes to publish this week in order to meet the Government's obligations under the Industry Act. He was particularly concerned that the Prime Minister see it today, and I have therefore asked the Duty Clerk to bring it urgently to her attention.

The forecast will appear as a supplement to the Treasury's Economic Progress Report. In view of the comments and questions which have already arisen it is very desirable to publish this week. Moreover, a rigorous interpretation of the Industry Act probably implies publication by 20 November. We therefore need to finalise the text on Tuesday, and should be grateful for any comments the Prime Minister may have as soon as possible. I regret the urgency; this arises from the conflicting pressures of the statutory deadline and the need to take account of last week's measures.

The draft is however very much on the lines which the Chancellor discussed with the Prime Minister on 5 November. There are perhaps three features of particular note.

1. Inflation

The RPI forecast of 14% (for the first quarter of 1980 compared with the year previously) is the figure already agreed between the Chancellor and the Prime Minister. It now looks on the optimistic side in the light of the recent level of pay settlements and the rise in interest rates, which is likely to affect the RPI through the mortgage rate. Nevertheless, this figure may be the best compromise between a higher figure which could adversely affect expectations and a lower figure which would be greeted with incredulity.

2. The PSBR

Since the precedent has been to include the PSBR in the next financial year in the autumn forecasts the Chancellor has concluded that simply to exclude it would create the suspicion that prospects were much worse than the Government actually thought. Equally, however, it is most undesirable to offer a precise figure which can so easily get turned into an inescapable requirement. The draft compromises by emphasising the large margins of error and the arbitrary policy assumptions involved; and by referring to the PSBR only as a percentage of GDP and not as a sum of money. In fact, it is necessary to say only that the percentage is much the same as the forecast we have given in 1979/80.

3. The Recession

The forecast shows quite a severe recession - a 2% fall in GDP volume between 1979 and 1980. This is a somewhat sharper fall than most other forecasters have predicted so far, though rather less than the internal Treasury forecast. However, the outside users of the Treasury model have come up with

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bigger falls in GDP, and although there is no necessary relationship between the model and the forecast, too big a gap would prompt questions. Although the Chancellor does not want to exaggerate the gloom it may not be unhelpful to indicate that present inflationary trends are bound to have adverse consequences; and to make it clear that the Government is fully prepared for a difficult period in carrying through its policy of bringing down inflation by firm control of the money supply.

Yes, Mr,

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Private Secretary

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ECONOMIC PROSPECTS FOR 1980

This supplement reviews economic developments so far this year and presents revised Government forecasts, now extended to the end of 1980.

Summary

2 In difficult world conditions and with a recent history of excessive inflation the UK economy is likely to experience some decline in economic activity in 1980. The priority in economic policy will be to counteract inflation by adherence to a declining path of monetary growth combined with the necessary fiscal restraint. The recent trend to accelerating inflation should be reversed in 1980, but the growth of the RPI during the year is still likely to be of the order of 14%. During the period of adjustment to a lower rate of inflation some adverse effects on international competitiveness, profitability and personal real incomes are almost inevitable. Any quantitative assessment of prospects is subject in present circumstances to very large uncertainties: the figures put forward should not be interpreted as indicating anything more precise than that the rate of inflation next year - though declining - is likely to remain in double figures and that there will probably be some fall in real GDP.

Recent developments

3 The higher rate of inflation over the past twelve months has reflected both high pay settlements and rises in oil and other commodity prices. Prices of materials and fuel used by manufacturing industry rose by some 20% in the year to October, indicating the significant non-wage element in inflationary pressure, even though this was greatly mitigated by the strength of sterling, for which the effective rate appreciated by ~~over~~ ^{nearly} 10% in the same period. The domestic rate of inflation, as measured either by retail prices or the wholesale price of (non-food) manufactures stood at about 17% over the twelve month period. The TPI, which takes account of direct as well as indirect taxation had risen by a little under 15%. Taken in conjunction with pay increases of some 15-16% on an underlying basis the real value of earnings was still increasing, though the improvement was considerably smaller than it had been in the early months of the year and in 1978, when the trend of commodity prices had been much more favourable. The combination of an appreciating exchange rate and a relatively high rate of domestic inflation has led to a sharp loss of international competitiveness in terms of both prices and costs.

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4 The rate of monetary growth in the past twelve months has been over 13%. In banking October, the latest month for which figures are available, sterling M3 grew by 2% taking the annual rate of growth since the beginning of the Government's target period in mid-June to just over 14%. This rapid growth occurred in spite of the rise in MLR from 12% to 14% at the time of the Budget and the fact that recorded growth of sterling M3 has increasingly tended to understate underlying monetary growth. This recent rapid growth reflects in part the high PSBR in the first half of the financial year. The measures announced in the Budget which increase the PSBR, such as the income tax reductions, were expected to come through faster than those which reduce it, such as higher VAT and sales of public sector assets. Also, borrowing by local authorities and public corporations was higher than expected, partly as a result of industrial action at the Post Office which substantially delayed payment of telephone bills. In addition bank lending has been growing extremely rapidly since the turn of the year, to some extent reflecting an unexpectedly buoyant rate of stockbuilding.

4a After the Budget interest rates remained remarkably stable - at about 14% at the short end and about 12½% at the long end - for around four months. But in October interest rates rose further, reflecting both increases in overseas rates, including those in the US, and fears about the continuing rapid rate of monetary growth. On 15 November an increase in MLR from 14% to 17% was announced, and at the same time the Government announced a rolling forward of the 7-11% target range for a further six months. The target now relates to monetary growth at an annual rate in the sixteen month period from mid-June 1979 to mid-October 1980. In addition it was announced that the Supplementary Special Deposits scheme was to be extended for a further six months, with the permitted rate of growth of interest bearing eligible liabilities remaining at 1% per month.

5 The weak recovery from the 1974/75 recession was checked in the autumn of 1978 and followed by a fall in activity in the early months of 1979, largely because production was disrupted by bad weather and industrial disputes. There was a marked rebound in output in the second quarter, but there has probably been a further drop in the third quarter partly as a result of the engineering industry dispute and the trend of activity over the past twelve months has probably been fairly flat. The manufacturing sector has reflected a broadly similar pattern to GDP in total. Despite the lack of output growth employment in industry has declined only marginally and unemployment was on a downward trend until the summer of 1979, though this appears to have been checked in recent months.

6 Personal consumption has added to demand but there appears to have been little change in public sector demand or in private sector investment. An increasing share of consumption has been met by growth of imports rather than by domestic production.

7 The growth of personal consumption reflected brisk growth in real personal disposable incomes in the period up to mid-1979. The precise timing of both income and consumption movements are complicated by the short-term effects of Budget changes. Taking the first nine months of 1979 the level of personal consumption rose by some 4½% compared with a year previously; this was probably a little below the growth in real incomes over the same period. The fall in consumption in the third quarter of 1979 partly reflected the effect of the Budget which had brought forward expenditure into the second quarter; in view of the trend in prices and real incomes the strong upward movement in consumption has probably now ceased.

8 Private sector investment in distributive and service industries was on a strong upward trend until mid year, but manufacturing investment appeared to have passed a cyclical peak and private sector housing investment had declined sharply. Stockbuilding has remained at a fairly high level so far this year albeit with erratic quarterly fluctuations. Public sector expenditure on goods and services has remained roughly constant.

9 The quarterly path of overseas trade has been greatly obscured and damaged by industrial disputes. It may be best to compare the first ten months of 1979 with the equivalent period of 1978. In this period export volumes (excluding fuel) rose only marginally (¼%) while import volumes (excluding fuel) rose by 14% with a substantially larger growth in imports of manufactures. These movements reflected strong consumer demand and worsening competitiveness while some exports are likely to have been permanently lost as a result of industrial disputes. Despite favourable terms of trade (reflecting the strong exchange rate) and continuing improvement in the balance of trade in oil the visible balance deteriorated and over the first ten months of 1979 was in deficit by some £3 billion. The invisible surplus, on provisional figures, has also deteriorated. This reflects an estimated worsening of the services balance as well as rising North Sea oil profits accruing to foreign owned companies and some further increase in UK net contributions to the EEC. Over the first ten months of 1979 the current account is provisionally estimated to have been in deficit by some £2½ billion. It remains highly uncertain to what extent this deficit reflects temporary disturbances.

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PROSPECTS FOR 1980

Policy assumptions

10 The forecast takes account of the measures announced on November 15 and assumes that monetary growth is held within the new target range. Public expenditure plans for 1980-81 are as set out in the recent White Paper (Cmd. 7746). For the purpose of this forecast tax receipts are projected on the conventional assumption that allowances, thresholds and specific tax rates are uprated in line with the RPI growth during the previous calendar year.

Inflation

11 Prices in the UK are currently rising at or a little above 1% per month. In the current quarter, the retail price index is likely to be some 17% higher than a year earlier (consistent with the Budget forecast), a rate which includes the once-and-for-all effects of the rise in VAT. Prospects for 1980 depend mainly on rises in domestic costs and in import prices. The effective exchange rate is assumed to remain close to its present level in 1980, so that rises in import prices reflect rises in world prices: although the long-awaited recession in industrial countries may limit any rise in commodity prices, some of the effects of higher import prices that have occurred so far this year will still be feeding through into domestic prices in the early part of next year. The growth of domestic costs depends, essentially, on the climate of pay negotiations. This forecast allows for a progressive reduction in the rate of settlement over the coming year in response to the Government's fiscal and monetary policies. It leads to a forecast reduction in the rate of RPI inflation (over a twelve month period) to 14% in the fourth quarter of 1980. With the share of profits being adversely affected by the continued rise in labour costs and by the fall in economic activity, a significant fall in the rate of inflation must occur in the first instance through a slower growth of costs: there would seem little scope for reduction in the already exceptionally low level of profit margins.

Demand, trade, and activity

12 Taking account both of the weakness of activity and the large prospective pay increases in the public services a small fall in real personal incomes is likely in 1980. However, consumer confidence

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should be helped by the decline in the rate of price inflation, and the savings ratio is likely to fall. This leads to a forecast of a small rise in consumers' expenditure next year.

- 13 Industrial and commercial companies are likely to encounter difficult trading conditions next year, reflecting weak world demand and unfavourable UK competitiveness. The adverse effects on output and profitability, combined with tight monetary conditions, may lead to a downturn in private investment and stockbuilding, both of which appear, in any case, to be close to cyclical peaks. The forecast of private sector investment is strongly influenced by the latest surveys of firms' investment intentions undertaken by the Department of Industry and CBI. Private manufacturing investment is expected to show little change this year and then fall by about 7% next year, rather less than in some previous downturns. Little change is forecast for other private investment in 1980. Stockbuilding was unexpectedly high in the first half of 1979. A turning point is forecast around the end of this year as companies react to the falling away in demand and to financial pressure. The forecast is for destocking on a significant scale during 1980, implying a large turnaround (some 2% of GDP) between 1979 and 1980.
- 14 The forecast is for little change in the volume of general Government expenditure on goods and services in 1980. This is consistent with the plans in the White Paper on public expenditure in 1980-81 (Cmnd 7746).
- 15 The US is expected to enter a period of recession and growth in the other industrial countries is expected to slow down, but without coming to a halt altogether. Many governments are tightening policies in order to contain the inflationary impact of higher oil prices, with the result that inflation may be better contained than after the 1973-74 oil price rises. In common with most of the international economic organisations, a slowdown in world economic activity is expected next year. Economic growth in the main industrial countries is forecast to drop from 4% in 1978, to under 3% in 1979 and to around 1% in 1980. The growth in the volume of world

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trade is expected to be very slow but the growth of UK markets should be less affected as the imports of smaller OECD countries and OPEC - relatively more important to the UK - are expected to grow faster than trade in general. UK-weighted trade in manufactures, estimated to have risen 5-6% in 1979, may rise a further 4% in 1980. The implication of the forecast for UK inflation combined with the assumption of a constant effective exchange rate, is that the UK's cost and price competitiveness does not change greatly from its recent level.

16 After a period of stability, the share of UK exports of manufactures in world trade appears to have fallen in 1979, with the disruptions caused by industrial disputes in the UK, and probably some effects of worsening competitiveness, adding to the longer-term tendency of the UK to lose share in world markets. In 1980, world trade growth is liable to be weaker and the lagged effects of changes in competitiveness more strongly unfavourable, so that there may be little change in the volume of manufacturing exports.

17 For both import and export volumes this forecast gives some weight to the views of outside forecasters but it is still less optimistic than most on short-term trends in trade volumes. The import propensity has moved upwards in recent years, and fluctuates cyclically though erratically from year to year. With the fall in demand forecast for 1980, the volume of imports should decline. There is particular uncertainty about the forecast for imports of manufactures.

18 Although, largely for cyclical reasons, there may be no further growth next year in the share of demand met from overseas the fall in the main categories of domestic demand - with exports substantially unchanged - indicates some fall in economic activity next year: the forecast, subject of course to a large margin of error, is for a fall in GDP of the order of 2%.

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The current account

19 The terms of trade improved between 1977 and 1979 by about 7%. With little change assumed in the exchange rate and with commodity prices rising only slowly, some further improvement in the terms of trade may take place in 1980. On invisibles, the outturn so far this year is, on very provisional figures liable to substantial revision, a good deal less favourable than in 1978, partly as a result of higher payments to the EEC, higher profits earned by foreign companies operating in the North Sea, and higher interest rates in the UK. While there should be an improving trend in the balance of services, higher North Sea profits will continue to reduce the net balance on interests, profits and dividends. There could be some further deterioration in the total balance on invisibles next year.

20 In total, the current account of the balance of payments seems likely to be in substantial deficit this year, perhaps by ~~some~~ £2½ billion. The figure has / ^{been} affected to a substantial but incalculable extent by the effects of major industrial disputes such as those in the road haulage and engineering industry. Continuing poor performance by the motor industry has also been an important factor. In the absence of disputes on a comparable scale next year, the fall in demand for imports will probably be sufficient to bring about some improvement in the current account, though a significant deficit - possibly of the order of £2 billion - is still forecast.

Public Sector Borrowing

21 In the first six months of the current financial year the PSBR is provisionally estimated at £6½ billion. This is high in relation to the Budget forecast of £8½ billion for the year as a whole and reflects, in particular, higher than expected borrowing by local authorities and public corporations. There are, however, strong reasons for expecting a big reduction in the PSBR in the second half of the year: receipts from the higher rate of VAT and from the planned £1 billion of asset sales will be almost entirely in the second half of the year and the loss arising from the delays to telephone bills should be partially recovered, though the forecast assumes that £400 million is still outstanding at the end of the financial year. With great uncertainty still remaining the likely outcome now seems to be in the region of £9 billion before taking account of the acceleration of PRT payments announced on November 15. Allowing for the PRT change the forecast reverts to the Budget figure of £8½ billion (4½% of market price GDP).

22 For 1980-81 the prospect is inevitably affected both by large prospective increases in public service pay and by the poor outlook for economic activity. There are, however, some favourable factors such as a full year's receipts of VAT at the higher rate, the build-up of revenue from North Sea taxation and the recovery of the remaining backlog of Post Office receipts. On assumptions adopted for this forecast the prospect - subject of course to a very high margin of error - is for little change from the 1979-80 level in the PSBR as a percentage of GDP. In the absence of a fall in economic activity the prospect - given the same policy assumptions - would, of course, be more favourable. If, for example, stronger private sector activity led to no change in real GDP next year rather than the forecast 2% fall, the PSBR would be likely to fall by at least ½% of GDP. With rising GDP the PSBR would be reduced still further. It should also be noted that any projection of the PSBR at this stage reflects not only very high margins of error (past experience would suggest an average margin of error in either direction of some 2% of market price GDP) but also involves necessarily arbitrary or conventional assumptions about future policy decisions. Actual policies for the PSBR in 1980-81 will be determined at the time of the Budget in the light of developments in the economy and, above all, of the requirements for meeting the Government's monetary target.

Margins of error

23 At present any assessment involves unusually large uncertainties. In particular, there is no reliable way of using past experience to assess the pace at which inflation responds to the new emphasis of monetary and fiscal policy. This applies particularly to the effects of policy on expectations, both insofar as they influence pay settlements directly and insofar as they influence financial markets and hence, in turn, the exchange rate, domestic prices and pay settlements. Similarly, because of the loss of trading competitiveness, which has occurred and is assumed not to be corrected, the forecast is particularly sensitive to fallible estimates of cost and price elasticities. Given a pronounced cycle the response of investment and stockbuilding to movements in output, profitability and financial conditions is also important.

24 In the circumstances it is not sufficient to use margins of error based on the record of past forecasts and the assessment of uncertainty has to be fairly subjective. Nevertheless, the final column of table 1 shows the average errors obtained from past forecasts with a time horizon comparable to the present forecast for 1980. In addition to the arguments for believing that margins of error are bigger in present circumstances it should be emphasised that these are average errors which, by definition, have frequently been exceeded.

25 Given these qualifications the forecast should not be interpreted as suggesting much more than that retail price inflation is likely to slow down but to remain in double figures next year and that there will probably be some fall in real GDP.

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Table 1: Economic Prospects to end 1980

A. <u>Output and expenditure</u> <u>at constant 1975 prices</u>	1978	1979	Margins of error in 1980* per cent
	to 1979 percentage	to 1980 changes	
Gross Domestic Product (at factor cost)	1	-2	1½
Consumers' Expenditure	4	½	1½
General Government Expenditure on Goods and Services	½	0	1½
Public Corporations fixed investment	-4½	-4½	6½
Private sector investment	-2	-1	4
Exports of Goods and Services	1½	0	3½
Stockbuilding (as per cent of GDP)	¼	-2	¼
Imports of goods and services	11½	-2½	2½
B. <u>Balance of payments</u> <u>on current account</u>	1979	1980	£ billion
	£ billion		£ billion
	-2½	-2	2
C. <u>Retail Price Index</u>	percentage changes		per cent
	4th Quarter 1978 to	4th Quarter 1979 to	
	4th Quarter 1979	4th Quarter 1980	
	17½	14	4

*This margin applies to General Government consumption.

*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 errors are after adjustment for the effects of major changes, where excluded from the forecasts, in fiscal policy and hire purchase terms controls. Quarterly forecasts are grouped so as to be comparable with the changes between calendar years as shown. For a forecast made in quarter 0 the errors (both for the constant price magnitudes and for the current account) relate to the forecast changes between the "base year" (quarters -1 to -4) and the forecast period (quarters 1 to 4). The strict comparison with the present calendar year forecast would, of course, involve a base year comprising quarters 0 to -3. For the retail price index the margin relates to the percentage change between quarter 0 and quarter 4.

Although roughly appropriate in respect of time horizon and period covered these figures are likely to understate the true margins of error for the general reasons indicated in the concluding paragraphs of the text.

Table 2. Forecasts of expenditure, imports and gross domestic product

£ million at 1975 prices, seasonally adjusted												
	General Government expenditure on goods and services										Gross domestic product at factor cost	
	Consumers' expenditure	Final consumption	Fixed investment	Total	Other fixed investment	Exports of goods and services	Stock-building	Total final expenditure	less Imports of goods and services	less Adjustment to factor cost	Status-adjustment	GDP index 1975=100
1977	63350	23250	3950	27200	16200	31700	1250	139700	30400	10850	-200	98250 105.1
1978	66700	23650	3350	27000	17150	32350	1100	144300	31600	11850	0	100850 107.9
1979	69300	23900	3200	27100	16650	32850	1450	147350	35300	12300	1550	101900 109.1
1980	69600	24150	3050	27200	16400	32800	-450	145550	34400	12250	500	100150 107.0
1978 First half	32950	11750	1750	13500	8650	15900	600	71600	15700	5900	-50	49950 106.9
1978 Second half	33750	11900	1600	13500	8500	16450	500	72700	15900	5950	50	50900 108.9
1979 First half	34900	11850	1650	13500	8200	15950	800	73350	17600	6200	1050	50900 108.9
1979 Second half	34400	12050	1550	13600	8450	16900	650	74000	17700	6100	500	51000 109.2
1980 First half	35000	12100	1500	13600	8300	16500	-50	73350	17300	6150	250	50450 107.9
1980 Second half	34850	12050	1500	13550	8100	16300	-400	72400	17150	6100	250	49700 106.4
Percentage changes												
1977 to 1978	5½	1½	-15	-1	6	2		3½	4	9½		2½
1978 to 1979	4	1	-4	½	-3	1½		2	11½	3½		1
1979 to 1980	½	1	-7	0	-1½	0		-1	-2½	0		2
Because of rounding half-year totals do not always sum exactly to the annual figures or the components of expenditure to total final expenditure.												