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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Fred Atkinson
Mr Byatt
Mr Unwin
Mr Welsh
Mr Ridley
Mr Sedgwick

FORECASTS : THE BRAY SCHEDULE

I have seen a copy of the Financial Secretary's note to you of 24th August in which he advocates that we "abstain from the computerised model/forecasting business altogether".

I think you know my views on this well enough for me not to repeat the case for the macro-economic analytical work we do (of which forecasting is of course only a part). But I would like to take up one point in the Financial Secretary's minute, viz the statement that "we do not base policy on the forecasts".

With great respect, this is very much what we do do. Whatever may be the target variable which Governments aim at they need some sort of forecast in order to determine whether existing policy is or is not going to lead to its realisation. At present our two target variables are the money supply and the PSBR. Neither can be predicted without some forecasting ability. In the case of the PSBR a full set of public sector accounts which shows the borrowing requirement or the excess of expenditure over revenue requires, if it is to have any pretensions to accuracy, a national income analysis. For instance the yield of direct taxes depends on personal incomes and corporate profits, while the yield of indirect taxes depends upon expenditure, and hence indirectly on the savings ratio. The scale of some categories of public expenditure, eg unemployment benefit, depends crucially on the development of the economy. Of course prediction of these determinents of public revenue and expenditure is difficult and no-one can pretend that the Treasury's (or any other body's) forecasting techniques are as accurate as we would like. But given that decisions of policy down to the last £100 million of expenditure and revenue turn on our ex ante estimates of the PSBR it seems reasonable to me that we should aim to get the prediction as nearly right as

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we can. Whatever we choose to publish in the way of forecasts, the public will expect that the decisions needed to achieve the targets for the PSBR, have been taken in the light of the best available information.

Similar arguments apply to the money supply and interest rates. Monetary prospects in part depend on the outlook for the PSBR and the surpluses and deficits of the main sectors of the economy. (It is interesting to note that Greenwells acquire forecasts of these from the London Business School model.) Even for a given PSBR and given sectoral surpluses and deficits, the demand for money, and so the level of interest rates associated with any target for the money supply, will depend on developments in the economy.

At a more mundane level we also use forecasts (of prices) to determine the level of social security upratings each year. This of course is because we have to programme the whole operation six months or so ahead of the effective date.

What is more we do need a model and a simulating capability in order to say what any particular change in policy will have on the target variables. If we abandoned forecasting altogether we would not have much idea of how much eg expenditure had to be reduced to produce a desired reduction in the PSBR.

Finally given what certain fairly monetarist outsiders (Greenwells and the LBS) are saying about the need to adapt the target PSBR to the economic cycle, there is an implicit recognition among them that policy makers need to be able to assess what is going to happen to economic activity etc if they are to make sensible decisions.

DW.

DOUGLAS WASS
29th August 1979