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CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

1. The economic situation has not changed dramatically since the Budget, though the outlook for United States, and so world-wide, growth has worsened, while the prospect for inflation here has improved.

PROSPECTS

2. Over the next two years the prospects seem to be:-

a. World Outlook. The fall in United States output stopped in the second quarter, and there should be some resumed world-wide growth in the rest of this year and throughout 1983; but the level of world activity is likely to remain lower than we had earlier hoped. Oil prices are higher than we had assumed at Budget time: this improves our revenue take, though the effect on inflation is of course adverse.

b. Output. Our recovery has shown some hesitation in recent months, due to weaker trading conditions in many industrial countries and the temporary rise in interest rates at the end of last year. But the forward indicators point to a perceptible, though perhaps uneven, rise in output over the next year. The latest forecast is for 2 per cent growth in 1983.

c. Unemployment. The growth in output is unlikely to be fast enough to reverse the rising tide of unemployment, but may be sufficient to arrest it. We have to reckon on unemployment, on the wide definition, remaining around 3 million. Levels are rising steeply in our competitor countries.

d. Interest rates have fallen by about $3\frac{1}{2}$ points since last autumn, but further falls may depend on what happens in the United States, where rates, both nominal and real, are well above ours, and on our maintaining confidence at home.

e. Prices. Inflation has declined more rapidly than expected. The Budget forecast was for 9 per cent by the end of this year and $7\frac{1}{2}$ per cent by the middle of next year. In fact we now expect to hit 8 per cent by the end of this year, and about 7 per cent by the middle of next year. On past experience there must of course be a risk that, as the economy picks up, so too will the inflation rate. We need to do all we can to prevent this: continuing success on the pay front will be one key element.

3. These indicators from the latest Treasury forecast are summarised in the attached table. As we approach the next Election we should be able to point to an economy which is again growing (though with unemployment still very high); to major progress on inflation; to substantial achievements in productivity and competitiveness; and to considerable success in insulating ourselves from the pressures caused by high United States interest rates. In short, our attack on the fundamental malaise of the British economy is making progress and deserves to be sustained.

HAZARDS

4. This scenario is however at risk in a number of areas.

5. First, developments abroad. There remains a strong risk that United States interest rates will remain high - and could indeed go higher. And we cannot rule out the possibilities of international financial disorder deriving from major loan defaults, private banking failures, or exchange rate volatility.

6. Second, the domestic pay scene. The Ministerial Committee on Economic Strategy is discussing this: the key point is that another pay explosion could blow away much that we have achieved, on inflation, productivity and competitiveness. We need settlements in the coming pay round substantially lower than those in the one now ending.

7. Thirdly, and perhaps most important, we could, by omission or commission, lose the confidence of the markets, domestically and abroad. This could result from a bad pay round, but equally it could spring from any suggestion that we were relaxing our grip on public expenditure, or that we were prepared to reverse engines on the drive to reduce borrowing, or through failure to carry conviction about our determination to maintain non-inflationary monetary conditions. Loss of confidence for any of these reasons would affect the recovery through the exchange rate, and interest rates, and more generally.

THE BUDGET PROSPECT

8. At the time of the last Budget we saw room for tax reductions (over revalorisation) of only some £0.5 billion in the financial year 1983-84, assuming that the spending totals were held. This would be significantly less

than we were able to concede in the last Budget; and the latest forecast does not materially change the position. Yet the case for assisting recovery by further tax reductions for industry remains very strong. And the economic and political arguments for increasing incentives by raising personal tax thresholds are equally compelling.

9. To adopt the ostensibly "easy" course of borrowing more in order to permit tax reductions would be fatal to confidence. We must hold to the plans for reductions in the Public Sector Borrowing Requirement (PSBR) as a proportion of Gross Domestic Product which we have announced and so far delivered. The United States example demonstrates all too clearly the consequences of failure in this respect.

10. The 1981-82 PSBR was £1½ billion below forecast. Analysis however suggests that this shortfall will not be carried through into subsequent years. It has been taken into account in the latest forecast, which shows the PSBR this year and beyond remaining very close to the figures published at Budget time.

11. But this depends on holding, as the Chief Secretary, Treasury, proposes (C(82) 28), to the present spending plans, published only four months ago, and this entails accommodating substantial Falklands expenditure within the totals. If we were seen to be revising them upward, the effects on market confidence would be substantial and adverse.

12. Moreover, to increase the planning totals would mean a real possibility of tax increases next year. And to maintain market confidence, we would have to make it plain that we would not shrink from such increases. Yet the fact is that they would be wholly inconsistent with what the economy needs, and what we have in the past promised.

13. Far better to avoid all this. As paragraphs 2 and 3 above show, our monetary and fiscal policies are now starting to bring success, to change course would risk throwing away all that we have achieved, particulary on inflation.

POSITIVE ACTION

14. But, though I am confident that we are on the right course, and must stick to it, we shall want to consider if there is anything we can do to improve the pace.

15. I am clear that we must be seen to do more to counter unemployment. This does not mean a change of macro-economic policy. The consensus among our major partners in the Organisation for Economic Co-operation and Development, with the French now coming back into line, is that counter-inflationary policies, far from being an alternative to policies to counter unemployment, are the only ones which will create the conditions for lasting

jobs. To drop our efforts would merely store up new problems for the future, and would have a confidence backlash. But we need a drive to make sure that what is now being spent, eg by the Manpower Services Commission, or what has already been made available, is being deployed to maximum effect, and attracts maximum attention. And we need to keep the political initiative in overcoming, or at least exposing, trade union resistance to sensible low-cost schemes for getting people off the register and into useful work.

16. Nor have we yet done enough to publicise and effectively promote all the changes we have made in order to encourage enterprise. A new publicity campaign has been agreed, but the search for ways of eliminating obstacles to enterprise must also be stepped up. There are major economic and political prizes to be won here.

17. Thirdly, on industry's costs, our role is twofold. As well as working to secure further interest rates reductions (by ensuring that monetary conditions remain appropriate, seeking further to insulate our markets from the threat of another United States interest rate crisis, and helping to improve industry's access to medium-term finance), we need to encourage the further reduction of unit costs. This is not merely a matter of encouraging restraint in pay: industry must also be encouraged to go on improving efficiency, through investment and the necessary changes in working practices. This entails our supporting those whose efforts to secure higher productivity lead to industrial action, and stepping up our efforts to secure the removal of institutional and other obstacles to changes in working practices.

CONCLUSION

18. The economic prospects as we approach the last part of this Parliament are not unpromising (paragraphs 2 and 3), but there are risks (paragraphs 5-7). The greatest, and the one most within our power to avoid, is that of allowing ourselves to be sucked into a spiral of higher expenditure, and therefore higher tax (paragraphs 8-13). We must maintain our fiscal and monetary policies, so as to be able to go on bringing interest rates down, and this means maintaining our grip on public expenditure. Consistent with that, we can and must do more (paragraphs 14-17) to combat unemployment, unleash enterprise, and help industry improve its competitiveness.

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Treasury Chambers

8 July 1982

MAJOR ECONOMIC INDICATORS

[% change on previous year]	1979	1980	1981	1982 (1)	OECD (Major 6 excl UK) (2) 1982
GDP (1975 prices)	+ 1½	- 2½	- 2	+ 1	+ ¼ (4)
Retail prices (Q4)	17½	15½	12	8	6½
Average earnings (Q4)	18½	19½	11	8½	7¼
Exports of goods and services (1975 prices)	+ 2½	+ ½	- 1	+ ½	- ½
[Levels]	1979	1980	1981	1982	1982
Current balance (£ bn)	- 1	+ 3	+ 7	+ 2	+ 2
Unemployment (UK, %, ex. school leavers)	5½	7	10½	12¼	7¼
Interest rates (3-month)	17	14¾	15½	13 (3)	13

(1) Figures consistent with Treasury June forecast (confidential).
(2) US, Japan, Germany, France, Italy, Canada; Treasury forecast.
(3) Current level of 3-month interbank rates.
(4) Low growth forecast reflects Treasury forecast for US - GDP forecast to fall almost 1½ per cent in 1982.

Tax and Public Expenditure

	1979-80	1980-81	1981-82	1982-83 (a)	1983-84 (a)
Tax (b) as % GDP	30	31	33½	33	32½
Public expenditure (c) as % GDP	41	43½	44½	44½	43
PSBR as % GDP	5	6	3½	3¼	2¾

(a) Figures consistent with Treasury June forecast (confidential).
(b) Excludes National Insurance Contributions. As a proportion of GDP, NIC has risen from 6 per cent in 1979-80 to an estimated 7 per cent in 1982-83.
(c) Including debt interest.