3.37 PERSONAL AND CONFIDENTIAL

Prime Minister

Gloomy reading; especially the prospect of tax increases next year

MES 6/7

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PRIME MINISTER

THE SUMMER FORECAST

As you know, my paper C(83)21 for tomorrow's Cabinet does not refer to the latest forecast, and I hope that its high figures for the PSBR this year, and the fiscal adjustment next year, will not come out in the discussion. But I thought that you would like to see the attached note by Terry Burns: it picks up all the key points.

2. The version of the forecast which will be circulated in the usual way to economists in the main Departments which contribute to the exercise will not contain the PSBR and fiscal adjustment sections. Omitting them is regular practice. And I have given very firm instructions, which Terry Burns has reinforced, that the figures are not to get into circulation, given the probable market effects if they did. (Realistically, we must expect some leaks at some stage; but it is crucial that there should be none before we have, by announcing action on spending, demonstrated our resolve to get back on track.)

NL.

(N.L.)

6 July 1983

SUMMER FORECAST

The Budget forecast has been updated to take into account recent developments in the economy. The broad outlook for activity and inflation over the next two years is, if anything, a little better than previously expected. But there are emerging problems this year with substantially higher borrowing and monetary growth. The current account of the balance of payments is liable to be in deficit for a time.

Fiscal and monetary policies

2. The forecast takes as given tax rates and public expenditure plans in 1983-84. These now point to a PSBR approaching £12 billion or 4 per cent of GDP. In 1984-85, the assumption is made that taxes will be raised to reduce the PSBR to 2½ per cent of GDP. By how much it would be necessary to increase taxes in 1984-85 to meet this objective is very uncertain: latest estimates suggest £2 billion or more. With short-term interest rates assumed to be held at about their current levels, some overshooting of the monetary aggregates seems probable this financial year. Next year, however, if the course of public borrowing follows the path assumed in the MTFS, monetary growth rates should come back within their target range, permitting small cuts in interest rates.

Activity

3. Activity so far this year seems to have been a little stronger than previously expected. GDP in the first quarter of the year was about 3½ per cent higher than in the 1981 trough, retail sales are now above their record pre-Christmas levels and the period of destocking by industry seems to have come to an end. Overall, growth of about 2½ per cent is now forecast both this year and next.

4. Prospects would be rather better if there were not continued doubts about the strength of recovery in the rest of the world. Although forecasts for the US recovery have recently been revised upwards, activity is expected to remain depressed in most European countries. Continued difficulties are foreseen for the developing

untries and OPEC. This means that total world trade, weighted by the composition of our manufacturing exports, is expected to recover only slowly through this year. UK exports, helped by the improvement in cost competitiveness, should soon be expanding.

Per cent changes

	GNP growth (Major 6 countries)	World trade in Manufactures	UK Exports of Manufactures
1982	- ½	- 3	1
1983	2	- ½	- 3
1984	3	4	3½

5. Final domestic demand has been growing strongly since the beginning of last year. Consumers' expenditure, boosted by lower inflation and interest rates, and greater availability of bank, HP and mortgage credit is now perhaps 4 per cent higher than a year ago. With lower inflation expected to keep the savings ratio down well below the levels of 1979 to 1981, further sustained growth is forecast for personal consumption although the boom in durables may now be passing its peak. Buoyant levels of housing starts suggest a continued recovery in investment in dwellings and a stimulus to the construction sector.

6. Company expenditure has been held back over the last few years by low profitability and poor demand prospects. Indicators of much improved optimism in manufacturing, rising profits and consistently better responses to investment intentions surveys point to some improvement in company expenditure, particularly on fixed investment and stocks.

7. In the early stages of this recovery a substantial proportion of the growth in demand was met by imports rather than domestic production partly because of the relatively poor level of cost competitiveness. The swifter recovery predicted for UK domestic demand than for other developed countries (except the US) implies a much higher growth rate for imports than exports.

Constant prices — Per cent change

	Total Domestic Demand	Exports of Goods and Services	Imports of Goods and Services	UK Output
1982	3	½	5	1
1983	4	½	5½	2½
1984	2½	3½	5	2½

8. The steady growth of domestic output over the next two years is not expected to be fully matched by movements in labour productivity. The forecast growth in employment may not be very different from the projected increase in the population of working age, leaving unemployment perhaps not far from current levels.

Inflation

9. Progress on reducing inflation has been slightly better so far this year than expected. Despite the rise in mortgage rates, this better performance should continue. The flat path of prices in the late summer and autumn of last year and the falling-out of special factors from the RPI nevertheless means that some increase in the annual rate of increase in the RPI must be expected - perhaps back to 5½ per cent by the end of the year.

10. The recent further fall in inflation has been accompanied by a small improvement in profit margins: domestic costs have been held down by substantial gains in productivity in manufacturing, lower wage settlements (down to about 5½ per cent this pay round) and the reductions in NIS. Although it will be difficult for manufacturers to maintain recent rates of productivity growth, the subdued growth of nominal demand and continued competitive pressures should lead them to try to contain costs through further reductions in wage settlements in the forthcoming pay round.

11. Despite the sluggishness of the world recovery, commodity prices - excluding oil and food - have turned up fairly sharply this year. This and perhaps a tendency for the exchange rate to fall slowly could offset the effect of depressed domestic costs for a time, but the assumption of further falls in real world oil prices

(approaching a 20 per cent drop over two years) is likely to keep down the growth in costs in 1984, allowing some improvement in margins whilst rates of domestic price increase hold fairly steady.

Per cent changes

		Underlying whole economy average earnings	Private sector unit labour costs	RPI
Year to fourth quarter	1981	10½	7	12
Year to fourth quarter	1982	8½	2½	6
" "	1983	7	3½	5½
" "	1984	6½	5	5½

Current Account

12. The current account of the balance of payments moved back into deficit in April and May. It may well remain in deficit this year and next. The deterioration since the Budget forecast reflects firmer non-oil commodity prices this year and a wider disparity between the growth of demand in the UK economy and in the rest of the world.

Public Sector

13. Prospects for the PSBR in 1983-34 have deteriorated significantly since the Budget. In part, this reflects the higher-than-expected outturn for 1982-83. Spending by Central Government Departments (particularly defence) at the end of the financial year turned out much higher than suggested by previous indicators implying outturns for 1982-83 and hence probably later years much closer to cash limits. In addition, developments and information since the Budget suggest that some non-cash-limited programmes will exceed Estimates by larger amounts than previously expected. Borrowing by local authorities exceeded the Budget forecast in 1982-83; together with lower rate increases than expected at Budget time and new information from Local Authorities budgets this suggests rather higher borrowing also in 1983-84.

The central projection for the PSBR in 1983-84 now stands at just under £12 billion. Considerable uncertainty, however, always surrounds PSBR projections with gross revenue and expenditure flows in the public sector now approaching £200 billion per year. Errors of only 1 per cent on each side can imply a £4 billion error in the PSBR. In the past, forecasts made at this time of year have often differed by several billion pounds from the eventual outcome.

Other risks and uncertainties

15. As is customary, most of this note has referred to "central" projections for the major economic variables. In fact, there is considerable uncertainty about all the forecasts presented. As a guide to the risks involved, it is worth noting that average errors on GDP forecasts for the year ahead have been about 1 per cent, on prices over 2 per cent and on the current account equivalent to £2 billion.

16. Particular uncertainties at present must be the strength of the world recovery and the path of US interest rates, the balance of payments and - particularly given the size of recent revisions - the PSBR forecast. Reactions of domestic and overseas financial markets to this year's overshooting of the monetary aggregates, to a higher PSBR and to the turnaround in the current account position will also be crucial.