Econ Pol Strategy

MA

PPS/CHANCELLOR

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PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 21 December, are sidelined.

M M Deyes

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R.A

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18 January 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. Has Government downgraded £M3 and PSBR?

That is an extraordinary conclusion to draw from the Chancellor's statement on 2 December and from the evidence the Chancellor gave to TCSC Committee in December. Consistent emphasis on need to keep steady but not excessive downward pressure on monetary variables and to restrain government borrowing.

4. Restatement of Government strategy?

Budget is customarily the occasion for a full statement of economic policy. I am sure my rhF Chancellor intends no departure from this tradition.

5. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of 1982 Budget.

6. Date of 1982 Budget?

My rhF Leader of the House will announce date of Budget in near future.

7. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

8. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth of money GDP fallen sharply. Inflation rate halved. Some good features in monetary picture -outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

9. Why are high interest rates needed?

[UK has abandoned domestic control: rates now fixed in Wall Street - claim by D Blake in The Times 14 January]

Current level of interest rates has reflected both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1½ per cent since September.

10. Expectations for 1982 disappointing?

[See B2 for details of December Industry Act Forecast]

No. Clouds are clearly lifting. Further falls in inflation in prospect. A rise in output instead of a fall. Good export prospects and current balance will remain in surplus. Admittedly a gradual undramatic recovery, but UK operating in difficult economic environment. Appreciable progress made on improving competitiveness and productivity. Important to build on this.

11. Unemployment in 1982?

Prospects for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects: IAF broadly consistent with assumptions in Government Actuary Report that unemployment in 1982-83 will, on average, be 300,000 higher than in 1981-82. But if things go well - pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.]

12. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

13. Tax increases necessary?

Cannot foreshadow Budget. Undoubtedly, higher public spending makes prospects for PSBR, interest rates and burden of taxation next year more difficult. But, as rhF said in

2 December statement, on conventional assumptions figures point to a PSBR next year broadly in line with projections published at time of Budget. Final assessment must await Budget next year. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

14. Government should change course?

(a) Moderate reflation the answer?

Government recognise need to respond flexibility to economic situation, within framework of overall strategy. But no question of abandoning that strategy. Cannot throw away gains made so far by return to discredited policies. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing resurgence of inflation and undermining financial markets, and, as a consequence, interest rates rising further and faster. Even large reflationary packages yield relatively small benefits eg NIESR £5 billion package would reduce unemployment by only 150-300,000 after 5 years.

(b) £9 billion package proposed by Mr David Steel?

[Liberals' paper 'A Chance to Work' released 7 January]

To a large extent a blown-up recapitulation of their earlier programme. Costing and job benefits optimistic (£9 billion expenditure; £3 billion PSBR; 1½ millionjobs in three years) - inflation implicatons hidden behind reliance on incomes policy. Result rosy against other reflationary packages (e.g NIESR see 14 (a) above).

(c) Reintroduce exchange controls and join EMS?

EMS is not a panacea. But Government does fully support EMS as an important step in monetary co-operation and closer integration in the European Community. Have stated that UK will participate in the EMS exchange rate mechanism when conditions appropriate both for the system and ourselves. Question is kept under constant review.

(d) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Latest information on output, production and stocks - recession over?

[NB: Index of industrial production (November) due out 18 January - separate briefing will be supplied.]

Fall in output now over. GDP output on latest - revised - figures, is rising. Q3 1981 up $^2/_3$ per cent on Q2. Manufacturing output increased by 2 per cent in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking one-third that of H1 1981.// October* industrial production figures show continued improvement with manufacturing output up $2\frac{3}{4}$ per cent from low point (H1 1981). Autumn Industry Act forecast sees continuation of recovery in output.

2. Other evidence of improvement in economy?

[NB: Retail sales (December) figures due out 18 January. New cyclical indicators to be released 21 January.]

Engineering orders in 1981 show new orders total up 17 per cent on H2 1981; within this, export orders figure up 21 per cent. Retail sales figures for November* up 2 per cent on average for 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. November* cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

3. Government assessment of prospects

[New Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat.]

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*Latest available at time of writing.

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

4. Investment prospects gloomy?

[Q3 1981 figures show little change for manufacturers and distributors' capital investment since Q1. December DOI investment intentions survey indicates 2 per cent rise for combined total manufacturers distributors and services (MDS) in 1982, bigger increase in 1983, but 1 per cent fall for manufacturers in 1982 (upturn in H2 1982).]

Welcome signs that decline in MDS investment is over, and DOI intentions survey points to prospect of rising investment over next two years.

[IF PRESSED on further decline in manufacturers' investment:

Survey points to pick-up in manufacturing during 1982.

IF PRESSED on consistency with Treasury forecasts. Early days yet; but latest information not inconsistent with IAF.]

5. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	1/3	1	
CBI (Nov)	0	2/3	
Phillips & Drew (Jan)	0	¾	
OECD (Dec)	-¾	-½	
(IAF - for comparison)	½	1	

November NIESR Review contains only annual data, but commentary suggests low point reached in H1 1981, with prospect of some recovery.]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic seeing recovery delayed to H1 1982 (OECD) and H3 1982 (ITEM). ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

6. Higher interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

7. Recession worse than in the 1930s?

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[December total count was 2,941,000 (12.2 per cent) - third consecutive month showing slight decrease. Seasonally adjusted excluding school leavers figure was 2,782,000 (11.5 per cent) Employment Secretary conceded in ITV interview 17 December that January unemployment total likely to top 3 million. (Figures to be published 26 January)]

Unemployment rising much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month in H2 1981 compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut -(down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised and now show signs of some pick up. Vacancies improving too.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 indications are that total employment declined at half the rate in H1 1981 (150,000 compared with 300,000 per quarter).]

Decline in manufacturing employment showing signs of further marked slackening in 3 months to October 1981 (28,000 compared with about 50,000 per month earlier in year), and 80,000 per month in H2 1980.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED on whether unemployment will "peak" in 1982. Mr Burns referred in evidence to TCSC (December 1981) to unemployment assumption given to Government Actuary; said it was not far from Treasury assessments. GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in wider range especially for beyond next year.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment; (figure of £450 million estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. Treasury's internal revision of figure published in February 1981 Economic Progress Report not published so far - further articles likely to be published in EPR and Employment Gazette in near future.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed. As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

7. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

8. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 has been increased by £160 million to over £520 million, with additional £61 million for the young worker scheme starting on 6 January 1982. The new Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £600 million 1981? in 1982-82 and £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be almost £800 million more than in last Public Spending White Paper (revalued).

9. Need to bring system of industrial training up to date?

Agreed. The White Paper 'New Training Initiative' sets out action required in industry and education as well as lead that Government are giving. New Youth Training Scheme will guarantee a full year's foundation training to those leaving school at the minimum age. Government objective is that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. An "Open Tech" programme is being developed to make technical training available to those with ability to benefit from it.

10. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government. Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

2. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in his statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. Other factors will also be important, including monetary targets and outlook for pay and inflation.

3. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

4. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be greatest help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

5. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year).

Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

6. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

7. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982)

8. The burden of corporation tax is too high/not high enough?

The Green Paper is not concerned with the burden of corporation tax but with its structure. It does show, however that burden of corporation tax has more or less matched changes in company profitability. The related question of appropriate burden of corporation tax is not covered in Green Paper but will be considered by my rhF in reaching his Budget decisions.

9. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

10. North Sea fiscal regime?

See R2.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

[Outturn for current year expected to be in region of £107 billion against £105 billion (revalued and adjusted) in last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring; changes in circumstances could well lead to higher or lower total than £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

5. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

8. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with this, but keen tendering will mean the programmes should be carried out as planned.

9. Number of cash limits breached last year?

[Full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as White Paper (Cmnd 8437) on 4 December.]

In aggregate, central government voted cash limits in 1980-81 were underspent by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the throughout public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

12. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is smallest for over 14 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 90,000 (over 4 per cent).

13. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

14. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

15. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

16. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

17. Increased burden on industry?

Very conscious of harmful effect of large rate increases. But remedy lies with local authorities. Realism of Government's plans means that there is no need for high rate increases.

18. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to bar supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

19. Financial help to authorities hit by recent extreme weather?

As already announced, Government is prepared to give special financial assistance to local authorities who would otherwise suffer an undue financial burden because of effects of recent severe weather.

IF PRESSED: As in the past, assistance being offered is 75 per cent of net additional expenditure which local authorities have incurred as direct result of emergency, above a threshold of a penny rate product. [NB - NOT FOR USE - this precise wording is important.]

20. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

21. No protection for industry?

An alternative to non-domestic rates involves much wider, more difficult questions. But interests of non-domestic ratepayers will be a most important consideration in developing a policy on domestic rates. Government's continuing pressure on local authorities to reduce expenditure (through Bill, block grant, cut in RSG percentage) will help all ratepayers.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast published 2 December shows PSBR in 1981-82 was £10.2 billion; PSBR in April - September was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CGBR April-December was £10¾ billion.]

Effect of dispute (concluded July) was to add around £3 billion to the CGBR, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

F SOCIAL SECURITY

1. Increase in employees' national insurance contributions?

[Chancellor and Social Services Secretary announced on 2 December 1 per cent increase in employees' national insurance contribution (from 7.75 to 8.75 per cent) from April 1982, as part of review of National Insurance Contributions. Increase will help to increase TPI from April - see J3. Social Security Bill to implement this had 2nd Reading 16 December].

An increase in contributions was necessary to pay for increased benefit expenditure (notably retirement pensions), increased redundancy payments and to maintain expenditure on the health service. Relative share of these costs met by employers has increased in recent years; we consided it essential to avoid placing this additional burden on them. Employers will still be bearing a higher proportion of the burden than they did ten years ago.

2. What about Treasury Supplement?

[Bill provides for 1½ per cent reduction in Treasury Supplement - from 14.5 to 13 per cent].

Treasury Supplement represents only one part of cost of benefit expenditure met by the general taxpayer. If all such expenditure taken into account, general taxpayer will still be funding as high a proportion of benefit expenditure in 1982-83 as this year - and substantially more than a few years ago. Not, therefore, unreasonable for contributors, rather than general taxpayer, to meet these extra costs.

3. Burden on employers?

We have avoided making any increase in employers' rate of contributions. Some increase in cash burden is, however, inevitable simply because of higher earnings. In addition, upper earnings limit has been raised by £20 to £220 - which adds a relatively small additional cash burden. Cash payments expected to increase by around 7 per cent, that is, slightly less than our estimate of the movement between 1981-82 and 1982-83 in earnings (7.5 per cent) and substantially less than the movement in prices (10 per cent).

4. Balance on the Fund?

We are budgeting for a very small deficit (£9 million) this year. The accumulated balance in the National Insurance Fund is of order of £5 billion. This may seem large as a proportion of expenditure; it has, however, been falling, and now represents about 13 weeks benefit expenditure - as compared with 25 to 30 weeks ten years ago. A balance of some weeks expenditure is necessary to cope with emergencies such as flu epidemics and industrial disputes.

5. Restoration of shortfall on short term benefits (notably unemployment benefits)?

5. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

6. Restoration of shortfall on short term benefits (notably unemployment benefits?

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

7. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 15 per cent in September but have since fallen to 14½ per cent. Market rates firmed a little in December and have remained firm so far in January, in particular reflecting increases in US market rates]

Of course we want to see lower rates. But must proceed cautiously if we are not to let up in the fight against inflation. Clearing banks have already reduced base rates by 1½ per cent from their peak.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

5. Will there be an overshoot of money supply?

[£M3 increased by 0.2 per cent in banking December. Recorded increase in first ten months of target period was 12.6 per cent. (These statistics relate to new monetary sector introduced at mid-November - following introduction of new monetary control arrangements in August - which is wider than old banking sector as it includes all recognised banks, licensed deposit takers, and trustee savings banks. Effect of change was a once-for-all increase in level of £M3 which is excluded from growth figures given above.) Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high,

6. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) December. In nine months ending December the effect of the strike was to add around £3 billion to the CGBR.

7. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

8. Plans for modifying MTFS?

We shall consider the MTFS published with last year's Budget - but have no plans to revise the broad objectives. Too early to comment precisely on what form this will take, or how next year's financial targets will be presented.

8. But increase in bank lending not inflationary: house prices stagnant, retail sales flat or falling?

Very hard to distinguish upward pressure on prices due to bank lending from downward pressure due to other factors, especially falling real personal disposable incomes. Effect of higher bank lending will not be felt on prices immediately, but only with a lag. Could be some leakage from mortgage lending into general consumption.

10. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in December.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in December at 12 per cent, compared with lowest recent level of 10.9 per cent in July. Effect of increase in mortgage interest rates and of higher food prices estimated at about 0.2 per cent on December RPI. Industry Act forecast: 12 per cent by Q4 1981; 10 per cent Q4 1982.]

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See also P .]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be more; some less. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurance they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals considering offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. Offer to LA manuals higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[NUM have rejected revised offer worth 9.3 per cent on basic rates (Not to be quoted: 7.4 per cent on earnings); water manuals considering offer worth 9.1 per cent on rates, 8.8 per cent on earnings].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached. [IF PRESSED on prospects of miners' strike: I am confident that good sense will previal].

10. Private sector pay

[BL settled at 4½-5 per cent, National Engineering Agreement added only 5.1 per cent to basic rates; however Vauxhall manuals have settled at 7.9 per cent, Ford unions rejected 7.4 per cent. Cumulative average for private sector in round so far estimated at 7½ per cent by DE [NOT TO BE QUOTED], 8 per cent by CBI Databank survey].

There have been some welcome signs of lower wage settlements in the private sector so far in the pay round. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

*

[Increase in year on year growth from 9.3 per cent in September to 11.9 per cent in October may attract attention, though (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to October does not, however provide a useful indicator of recent trend in pay settlements.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Layard's wage inflation tax?

Like any other attempt to rely on incomes policy, Layard's proposal (picked up by SDP) would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

We are considering question of index-linking of public service and other public sector pensions, including the question of contributions made by public servants for their pensions. Changes in these arrangements could produce further savings in due course.

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* Latest available figure : November index will be published on Wednesday 20 January ,

K BALANCE OF PAYMENTS

1. Balance of payments in third quarter 1981

[Figures for invisibles and capital transactions published 9 December]

The capital account outflow in Q3 was much smaller than earlier in the year. Portfolio investment abroad (estimated at £1.3 billion in Q1) was only £0.6 billion in Q3. Total surplus on invisibles was £303 million.

2. What is happening to the trade account?

[November trade figures published 23 December]

November figures show that the current account continues in surplus.

3. Trends in exports

Exports are well up on a year ago: non-oil export volumes in three months to November were up 4 per cent on 1980. An increasing proportion of exports (now 24 per cent) go to developing countries.

4. Trends in imports

Across the board increase during last three months confirms recent evidence of slowdown in destocking, and recovery in output.

5. Trends in invisibles

Invisibles in Q4 1981 is projected at £167 million-much the same as in Q3.

6. Capital flows

The net capital outflow in 1981 Q3 was about £0.7 billion compared with £1.9 billion in 1981 Q2. These capital flows represent overseas investment which will provide a valuable source of overseas income in future years. There is no evidence that outflows deprive UK firms of capital to invest.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since last summer sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark, due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 15 January were $1.8745; DM4.31 and an effective rate of 90.60. Reserves at end December stood at $23.3 billion, compared with $23.4 billion at end November]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M8]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. We aimed to reduce official external debt to $14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only $13.3 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

Community Foreign Ministers met informally in Brussels on 14-15 January. The meeting did not solve all the outstanding problems, particularly in relation to the milk regime and the budget. But some progress was made. Foreign Ministers will consider matters further at their meeting on 25 January.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We are examining the new Commission estimates. If our adjusted net contribution in respect of 1980 and 1981 turns out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. <u>What is the current attitude of the UK Government?</u>

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

1. January NEDC meeting: Why did Chancellor refuse to analyse Mr Len Murray's reflationary package?

My rhf did not refuse to analyse on the Treasury forecasting model the effects of a suggested reflationary package of a £2 billion increase in public investment and a 2½ per cent cut in VAT. He is quite prepared to consider the effects of these and other policy options. But this work cannot be completed in time for February NEDC. In any case, a full agenda for the February Council has already been agreed with TUC and CBI.

2. January NEDC meeting: What was achieved?

There was a valuable discussion at the January Council, particularly on relationship between real wages and unemployment, both in the economy as a whole, and in respect of particular groups of workers, such as young, unskilled and in regions. The papers circulated by my rhf Chancellor stressed that the best hope for economic recovery lies in reducing wage and price increases further, and in sustaining recent rapid increase in industrial productivity.

3. Recent increases in interest rates - damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

4. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output rising in Q3 1981. Autumn Industry Forecast sees continuation of recovery in output.

5. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

6. Industry claims that 2 December package adds £600 million to employers' costs?

[Higher NIC £200 million; higher rates £400 million.]

In real terms burden of NIC/NIS on employer's likely to fall in 1982-83, for second year in succession. And company sector now in rather stronger financial position than a year ago, partly through Government policies to switch fiscal burden.

SMALL FIRMS

7. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

8. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued more than 1800 guarantees - well over half to new businesses. Total lending under scheme is already over £63 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

9. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

10. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Why not give British Telecom more?

The £340 million EFL is still relatively large, particularly for a profitable industry. Ministers will be looking to British Telecom, as to others, to make a substantial contribution through reduced costs. There could be a higher figure if the bond proves feasible.

5. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

6. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this year.

7. Future years?

Investment approvals for the years 1982-83, 1983-84 and 1984-85 have yet to be settled. They will be communicated to the industries in due course and will be published in the forthcoming Public Expenditure White Paper.

8. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries should be able, in total, to maintain broadly the same level of investment in 1982-83 as planned in the last White Paper, despite lower revenue, with higher investment in important industrial priorities, eg telecommunications. This will enable the 15 per cent real increase over the 1980-81 level, which was included in the 1981-82 plans to be sustained. These plans, in turn, represented the highest real level of investment in the industries since 1975-76.

9. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

10. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

11. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

12. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £350 million this year.

13. Nationalised industries not reducing high cost of overmanning?

6.6 per cent of working population are employed in nationalised industries. Nationalised industry manpower reductions since we came into office will reach 200,000 in 1982.

NATIONALISED INDUSTRY PAY AND PRICES

14. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. Alternative would have been an increased burden on taxpayer and distortion of market forces. But rate of nationalised industry price increases is now coming more closely into line with RPI.

15. Will HMG take action over electricity price rises to large users?

The CEGB's Bulk Supply Tariff Review has now been produced and is currently being considered by Ministers.

PRIVATISATION

16. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas Enterprise Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular in-house production. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute of Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

3. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

4. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

5. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

6. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The sale of 51 per cent of BNOC's upstream business next year means that an oil bond is no longer necessary.

7. Government "frittering away North Sea riches"?

[The Times 14 December].

No. Benefits of North Sea are being put to best advantage by reducing PSBR, interest rates, and non-oil taxes below what they would otherwise have been. Investment, both at home and overseas, is thus encouraged. Oil thus provides a valuable contribution to Government's economic objectives.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9½ per cent in November. Underlying rates falling in US and rising in Italy. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9½ per cent in November 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

4. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

5. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Recent Canadian Budget will reduce deficit.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

8. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

9. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to under 16 per cent from peak of 21½ per cent; also German rates declining.

10. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 18 January 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The Industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to November 1981 industrial output rose 1½ per cent while manufacturing output rose 1 per cent.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales in the 3 months to November 1981 were little changed. The volume of visible exports in the 3 months to November 1981 were 9 per cent above the average for January and February 1981. The volume of visible imports in the 3 months to November were 24 per cent higher than the average for January to April 1981. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,781,600 (11.5 per cent) at December count, up 17,300 on November. Vacancies rose slightly to 107,500 in December.

Wholesale input prices (fuel and materials) were unchanged in December; the year-on-year increase fell to 15½ per cent. Wholesale output prices rose ½ per cent and are 11¼ per cent above a year ago. Year-on-year RPI increase was 12.0 per cent in December. Year-on-year increase in average earnings was 11.9 per cent in October. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to December - £10.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 0.2 per cent in banking December.

Visible trade showed average monthly surplus of £135 million in the 3 months to November 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in first 11 months of 1981 estimated at £2.6 billion. Reserves at end-December $23.3 bn. At the close on 15 January the sterling exchange rate was $1.8685 and the effective rate was 90.6.