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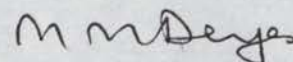
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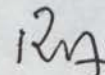
Mr Salveson (for transmission to No.10)  
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PS/Lord Privy Seal  
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PS/Secretary of State for Trade  
PS/Secretary of State for Energy  
PS/Secretary of State for Transport  
PS/Chancellor of the Duchy of Lancaster  
PS/Secretary of State for Employment  
PS/Paymaster General  
and officials in HMT, Revenue Departments  
and other Departments in Whitehall

**TREASURY WEEKLY BRIEF**

I attach the latest version of this Brief. Changes from the previous Brief, of 26 April, are sidelined.



M M DEYES



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30 April 1982

EB Division  
H M Treasury  
01-233-3364

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## 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. Falkland Islands: Cost/Financing of operation?

No cash ceiling on the cost of the operation; needs of task force must and will come first. When the cost is known we shall decide how to deal with it. But cost can and will be met in ways consistent with Government's economic strategy. [IF PRESSED: Not all of cost will be additional. At this stage, extra cost represents very small proportion of (over £14 billion) Defence Budget. No cash or budgetary problem immediately in prospect. Also complete nonsense to suggest that ability to respond to Falklands crisis has been weakened by Government's so-called cuts in defence spending. Government has actually increased defence spending by over 85 per cent in cash terms and about 11 per cent in real terms since 1978-79.]

### 3. Financial markets right to be worried by Falklands crisis?

No. Of course, markets are preoccupied with the dispute but it needs to be kept in perspective. UK is basically in a strong financial position: inflation is coming down; interest rates were falling before the crisis; balance of payments remains healthy; output is recovering. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. And the basic strengths in the economy have not changed (see Section J for latest interest rate position).

### 4. Contribution made by 9 March Budget to economic strategy?

Budget continues Government's medium-term strategy for economy. Designed to make further progress on inflation and restore base for economic growth, improved output and increased employment. Tax cuts and other measures designed to help both business and individuals, within responsible fiscal framework.

### 5. Not enough help for industry?

Main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates. In addition, specific Budget measures aimed at industry and business will

cost about £1 billion in 1982-83. Signs of recovery in profits and financial position of industrial and commercial companies. (See also Section P).

6. Budget did more for industry than for people?

Help to industry is help to people. Higher allowances and thresholds more than compensate for inflation in last year and make up some of ground lost last year. Many other smaller changes (eg on charities) will help particular groups of people.

7. Effect of Budget on personal incomes, incentives etc?

See Section D.

8. PSBR for 1981-82 only £8½ billion. Deliberately under-stated in 1982-83 FSBR?

See Section H.

9. Does this imply too tight fiscal policy?

Had PSBR been higher, so too would have interest rates. Important question now is what level of PSBR for 1982-83 is acceptable in terms of interest rates.

10. Scope for tax cuts in view of £8½ billion PSBR in 1981-82?

See D5.

11. Monetarism dead?

'Monetarism' a much over-used, misused and misunderstood word. Medium-term framework provides essential reference point for policy, but not being slavishly and dogmatically adhered to. Only right to take account of changing circumstances: that is what we have done. Such adjustments do not reflect any weakening in resolve to tackle inflation.

12. Government's impact on inflation disappointing?

Judged by results, policy is succeeding. 12-monthly inflation rate now 10½ per cent (March figure published 23 April) - down from 11 per cent in February. Single figure inflation rate expected well before end of year.

13. Economic recovery in doubt?

[February industrial production figures, published 15 April, show only relatively modest recovery from strikes/severe weather affecting December/January levels; industrial production still at broadly same level as last autumn]

No. Underlying levels of output above that of last Spring. Most forecasters, along with FSBR, expect continuation of recovery this year; and some see growth accelerating in 1983 (see also Section B).

14. Outlook for unemployment?

Budget forecast shows continuation of recovery; not the practice to publish estimates of the overall effects of the Budget, or its individual measures, on employment or output. (See also Section C)

15. Government not keeping to commitments to reduce expenditure?

Increases announced in Budget offset by reductions leaving totals still around £115 billion. FSBR shows declining ratio to GDP in future years. (See also Section E).

16. Armstrong/unified Budget?

[Reports in Press of TCSC draft of their report.]

Proposals have wide implications. Need careful consideration. Government does take account of tax and expenditure when taking decisions on each. Await TCSC report with interest.

17. Status of forecasts run through Treasury model?

[cf S Brittan article FT 29 April.]

No guarantee of good quality necessarily arises from running a forecast through the Treasury model. Model cannot be applied mechanically; results depend crucially on judgements involved.

- (i) Activity recovered by 1 per cent during 2H 1981. Most recent major independent forecasts see the prospect of recovery in 1982.
- (ii) Earnings and settlements. Increases halved in 1980-81 pay round. Public sector in line. There is a good deal of evidence that average settlements in private sector are running lower than in the 1980-81 round. [CBI pay data bank for manufacturing settlements suggests average is now around 7 per cent compared with 9 per cent in previous round.]
- (iii) Manufacturing productivity. Output per head rose 10 per cent during 1981. Output per head and output per person  $3\frac{1}{2}$  and  $6\frac{1}{2}$  per cent higher than previous peak in 1H 1979.
- (iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs over last year - about 3 per cent in 3 months to February 1982 on a year earlier. Recent rate of increase below the average of our major competitors and comparable to that of Germany and Japan.
- (v) Competitiveness. Cost competitiveness improved by over 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.
- (vi) Profits: Industrial and commercial companies gross trading profits (excluding N.Sea and net of stock appreciation) rose strongly during 1981, up over 25 per cent between 1H and 2H 1981.
- (vii) Exports have held up better than many feared (but low January figures have undermined earlier favourable comparison - non oil exports Sept '81 to Jan '82 up only 1 per cent in 1980). Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.
- (viii) Unemployment. Rate of increase in unemployment has slowed further this year to just  $\frac{1}{4}$  that of a year earlier. Vacancies improved since mid 1981. Short-time working in manufacturing reduced by over  $\frac{1}{3}$ 's since January 1981 and overtime working has increased.
- (ix) Special employment measures. Total provision on Job Release Scheme, Temporary Short-Time Working Compensation and Community Enterprise Programme in 1982-83 now planned to reach over £520 million, with additional £61 million for young worker scheme (starting January 1982). Spending on Youth Opportunities Programme to rise to £700 million in 1982-83. 280,000 unemployed school-leavers last year found places on YOP by Christmas.
- (x) Training. Over next 3 years £4 million to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.
- (xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Inflation. Increase in RPI more than halved since peak (21.9 per cent) in Spring 1980. 12 monthly RPI increase in March of 10.4 per cent. Wholesale price inflation in single figures - 9½ per cent in year to March.

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 400. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover some 270 thousand employees.

(xiv) Examples of export successes reported in the Press include: £5 million plus order secured by Manchester firm (NEI-APE Ltd) for engines to power five petrol boats being built for Hong Kong Government via Scottish shipyard (Hall Russel and Co); computer-system for handling chemical structures bought by two Japanese pharmaceutical companies (Fraser Williams (Scientific Systems Ltd)).

(xvii) Overseas investment in UK: US direct investment in Britain amounted to stock of over \$14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xviii) Overseas debt repayments. Official external debt reduced from over \$13.3 billion at end-1981.

Innovation. Total of industrial robots in use in UK reached 713 last year; expected to pass 1000 this summer, UK is fifth in World league table of robot users.

## B ECONOMIC ACTIVITY AND PROSPECTS

### 1. Recent position?

All three GDP measures were higher in real terms in Q4 1981 than had been earlier in year. GDP (output) in Q4 was nearly 1 per cent up on Q2 - the earlier low point.

[IF PRESSED on apparent weakening of recovery (based on November/December/January industrial production) - see 2 below.

### 2. Recent industrial and manufacturing production figures show resumed decline?

[Latest industrial and manufacturing production figures show upward revision to January's index removing decline shown last month and some bounceback in February's index to level of last November.].

Latest figures (including revisions) show that as expected February saw some recovery from weather and strike effected levels at turn of year; and that effect of these in January was less than earlier presumed. CSO's press notice clearly states that underlying level of output above low point of spring of last year. Industrial and manufacturing output in 4Q 1981 some 2-3 per cent above low point earlier in year.

### 3. Business opinion

[NB CBI's Quarterly Industrial Trends Survey for April to be published Wednesday 5 May.]

March business opinion surveys show encouraging improvement. CBI's monthly enquiry saw further improvement in order books, and rise (to 4 per cent) in net balance of firms expecting to increase output in next four months. FT business opinion survey corroborates this, and shows increased business optimism.

### 4. Other evidence of improvement in economy?

See Bull Points (following Section A).

### 5. Government assessment of prospects

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

	per cent increase on year earlier	
	1982	1983 H1
GDP	1½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4½	5
Exports	3½	3

Forecast expects some stockbuilding in 1982, Government expenditure flat.]



FSBR forecast sees prospect of some recovery continuing into 1983. (Last two Government assessments of economy were broadly correct). Healthy rise in private sector investment and exports. Inflation well into single figures (7½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

#### 6. Outside forecasts

[GDP profile in major post-Budget assessments:

	<u>NIESR</u>	<u>LBS</u>	<u>St James</u>	<u>Phillips &amp; Drew</u>	<u>CEPG</u>	<u>FSBR</u>
	(March)	(March)	(March)	(April)	(April)	(March)
Per cent change 1982 on 1981	+1½	+1½	+1½	+1½	-½	+1½]

Nearly all see prospect of continued recovery in 1982 in line with FSBR, (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see inflation at 8-9½ per cent by Q4 1982 - also in line with FSBR. [See also C4 (unemployment), K4 (inflation) and L10 (balance of payments).]

#### 7. Cambridge Economic Policy Review gloomy forecast?

[Document published 26 April gives base projection and assessment of results alternative policies.]

Base projection is, as usual, somewhat out of line with both the FSBR and other forecasts (more pessimistic on growth and more optimistic on inflation; notably CEPG forecasts for output and exports in 1981 were well wide of the mark - predictably, on side of pessimism. Analysis of alternative policies supports view that even substantial reflation would produce few jobs - £30 billion over 3 years estimated to reduce unemployment by 300,000 after 2 years, thereafter gain starts to be reversed. CEPG also admit that reflation 'is not in itself capable of generating sustained recovery'.

C LABOUR MARKET

1. Recent unemployment figures?

[Unemployment (UK adult seasonally adjusted) rose by 28,000 to 2,850,000 (11.9 per cent) in April. Total unemployment rose by 15,000 to 3,008,000 (12.6 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980					
Q4	Q1	Q2	Q3	Q4	First 4 months
105	77	62	51	33	23 ]

April's rise (though higher than very low increases in February and March) suggests further slowing down of rise in unemployment this year.

2. Vacancy figures disappointing?

[Vacancies (UK seasonally adjusted) fell slightly for second consecutive month to 110,000 in April, compared with 113,000 in February. Vacancy flow data for March (latest month available) show continued rise in outflow.]

Despite slight falls in last two months, vacancies still  $\frac{1}{4}$  higher than at low point in Q2 1981 and flow (ie vacancy turnover) has improved.

3. Effect of Budget on unemployment?

Budget contributes to Government strategy of fostering conditions for sustainable growth. Help to business will lay foundation for more real jobs. Employment will benefit from some further improvement in activity. Proposed new non-profit-making scheme will enable local authorities and voluntary sponsors to provide many new jobs. (MSC to advise what possible: for illustration, Government prepared finance 100,000 at net additional Exchequer cost of £150 million).

4. Unemployment expected to continue rising rapidly?

[Outside forecasters see continued rise in registered unemployment during 1982 reaching about 3 million (UK adults) in Q4. Opinion divided for 1983; some (CEPG, Cambridge Econometrics, ITEM, NIESR) see rise continuing but at a slower rate, some broadly flat (LBS, St James) others (P&D, S & Coats) expect slight (roughly 50-100,000) fall in 1983. Liverpool foresee fall of 400,000.]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment drastically reduced since end 1980. Clear evidence of further slowing down this year - Q1

1982 rise just 1/5 that in Q4 1980. Vacancies, short time and overtime all improved last year. Employment situation will benefit from some further recovery in activity this year.

5. CEPG expect 4½ million unemployed by 1990?

As always there is a range of unemployment forecasts, with CEPG amongst most pessimistic (see parenthesis to 4 above). Notably, CEPG unemployment forecasts now less pessimistic than a year ago.

6. Government forecasts for unemployment

[1982 PEWP uses working assumption of an average level of 2.9 million unemployed in Great Britain (excluding school leavers) in 1982-83 and rest of survey period. School leavers, adult students, temporarily stopped and Northern Ireland imply UK total unemployed of 3.2 million in 1982-83.]

Very difficult to forecast. Following well-established precedent of previous administrations is not publishing. Public Expenditure White Paper figures are planning assumptions not forecasts.

IF PRESSED that PEWP figures show Government planning sustained higher level of unemployment: No. Maintaining constant figure for the Survey period is conventional assumption adopted by previous Administration. PEWP 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 - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

7. Employment continuing to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Provisional Q4 figures indicate decline of about 200,000 compared with 150,000 in Q3 and 300,000 per quarter in H1 1981.]

Decline in H2 1981 almost half that in H1. Other labour market indicators improving (see C1, 2 and 4 above).

8. Unemployment higher than in other countries?

[On standardised definitions in 3Q 1981 UK employment was 11½ per cent compared with 6½ per cent OECD rate; a UK doubling compared with an OECD rise of a third since 1979.]

Whole world affected by rising unemployment. In our case we have additional self inflicted wounds of high pay awards and low productivity. Unemployment now rising very fast in some countries eg Germany.

9. High Exchequer costs of unemployment? Recent Treasury estimates suppressed?

[Mr Varley in interview LBC 26 April suggested £15 billion a year.]

No 'right' figure. Estimates depend critically on assumptions used, the causes of unemployment and items of 'cost' covered. [IF PRESSED: Estimates have been made of cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). Attempt made to update to 1981-82 - range of figures has been calculated. But doubts expressed about assumptions used. Work, therefore, continues. No decision whether to publish.] Cannot gross up such figures to produce total cost (in terms of lost taxes and extra benefits) of all the unemployed. Meaningless concept. Implies comparison with an economy with zero unemployment. Can say total expenditure on unemployment and supplementary benefits paid to the unemployed estimated at £4.3 billion in 1981-82 and £5 billion in 1982-83.

10. What is Government doing to provide more jobs?

Illusion to think Government can switch employment off and on like a tap. Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and new measure announced in Budget. (See C3).

## D TAXATION

### 1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) 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 and 39½ per cent in 1982-83.]

This has inevitably increased during a time when the recession has been adding to public spending. Changes proposed in Budget will reduce total burden next year compared with 1981-82. [NB: Not true of burden on persons.]

### 2. Burden of tax has risen for most households since 1978-79?

[Comparisons given in Parliamentary Answers to Mr Straw 3 December, 17 February and 18 March col W199.]

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But real personal income after direct taxes still higher than under last Government. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

### 3. Burden has fallen for the rich?

Only because of abolition of absurdly high marginal rates and raising of thresholds in 1979 Budget.

### 4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall next year (82-3) for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

### 5. Scope for tax cuts because of lower than expected PSBR in 1981-82?

No reason to believe that PSBR in 1982-83 will be higher than forecast (see H4). Government want to cut taxes further, when economic circumstances permit, but more tax cuts too soon could jeopardise recovery.

### 6. Personal tax burden increased by recent Budget - when NICs taken into account?

[Full explanation given in Parliamentary Answer 11 March OA col 955].

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers will benefit from income tax changes and will be unaffected by NIC rise, and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc will compensate for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the

Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC will rise for most people, but will fall for the lowest paid (below about ½ average earnings (married) and below about 1/3 average earnings (single).]

7. No improvement in incentives?

There will be 1.2 million fewer taxpayers than if allowances had remained at 1981-82 levels, and ½ million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

8. No help on poverty trap?

Numbers in Poverty Trap should not be exaggerated. Increases in income tax allowances have a beneficial impact. [IF PRESSED: overall, small increase in numbers in poverty trap (10,000) as result of FIS uprating. But this helps low paid and generally makes employment more attractive than unemployment.]

9. Poverty trap/'why work? syndrome' need investigation?

Whole question of interaction between income tax and social security benefits being examined by TCSC Sub-committee (chaired by Mr Meacher). This is a complex area; the sub-committee is a more suitable forum for discussion.

10. Budget reduction in NIS not enough to industry?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. 1 per cent reduction maximum possible without risks for PSBR: outright abolition too costly. And other measures to help business directly - energy, construction, innovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section P).

11. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

12. Government take from North Sea oil too high?

See S1.

## E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

### 1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g. additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). [NB 1981-82 ratio could be nearer 44½ per cent. See H5.] Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure. (See also H5)

### 3. Cuts in defence spending have weakened our ability to respond to Falklands crisis?

No. We have not cut defence spending since 1978-79. We have increased it by over 85 per cent in cash terms - a real increase of about 11 per cent - to over £14 billion. We are spending more on conventional naval forces in real terms than was spent in year before we came to office. When expenditure on modernising strategic deterrent is at its peak we will still be spending more on conventional Navy than in 1978-79.

### 4. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

5. Real terms comparisons

No volume equivalents of cash plans. But cash increase in plans between years is 9 per cent in 1982-83, 5 per cent in 1983-84 and 6 per cent in 1984-85 (and projection of GDP deflator in MTFIS is rather lower than this in 1982-83, rather higher in 1983-84 and about same in 1984-85). So in cost terms [i.e cash inflated/deflated by general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

6. Plans unrealistic, given e.g overspending in 1981-82/future rates of inflation?

Total spending in 1981-82 expected to be only a little [NOT FOR USE: 0.4 per cent] higher than planned a year ago. Major reason for overspending is present level of spending by local authorities; this has been taken into account in plans. Realism, particularly in respect of local authorities and nationalised industries, is one reason why plans for future years are higher than in previous White Paper. Large Contingency Reserves due to greater uncertainty in later years and designed to give realistic planning totals.

7. Higher inflation than allowed for in PEWP may raise public spending?

True that inflation assumption in FSBR slightly higher than in PEWP, but:

- for 1982-83 confident that planning total including Contingency Reserve will hold;
- for later years inflation assumption in FSBR a little higher than cost factors used in building up cash programmes;
- in due course, will consider adequacy of cash provision on programmes.

Meantime, uncertainties due to, for example, inflation, are one reason for large Contingency Reserves in later years; makes for realistic planning totals.

8. NIS reduction: effect on public expenditure?

[Programmes will be reduced to reflect reduction in NIS paid by public sector. First estimates of effect (included in post-Budget revised planning totals) is some £360 million in 1982-83 and £450-500 million in later years.]

Government's intention in reducing NIS is to help private industry, not public sector. Effect of clawback on public sector will leave its position broadly unchanged. (See also P2).



9. Not enough capital expenditure?

Government prepared to give priority to worthwhile capital projects wherever this can be done within overall spending totals. Plans do allow for changes between 1981-82 and 1982-83 as follows:

- public sector spending on new construction increased by 14 per cent;
- nationalised industries investment to rise by 26 per cent;
- increase in housing investment output [NOTE: if LAs take full advantage of receipts from sales, gross new investment can be as high as £3 billion next year];
- slight increase in work done on water and sewerage projects even though provision reduced).

10. Cuts in capital

Some reductions in cash provision necessary, but recent falls in tender prices (following sharp increases between 1978 and 1980) will mean that programmes mainly affected (roads, water, local environmental services) should be carried out as planned. Planned capital expenditure also reflects decline in needs since early mid-1970s (e.g roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

11. TCSC criticise change to cash planning?

The TCSC do not dispute decision to change to cash planning. They are concerned rather with presentation of figures.

12. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

13. Cash figures should be accompanied by constant price figures to give some idea of levels of service?

Constant price figures of limited value in new situation. Cash programmes intended to have primacy. Necessary to get away from old system of volume planning and destroy idea that programme managers automatically entitled to be compensated for effects of inflation by

revaluing their programmes. In any case old 'volume' figures not a measure of level of service. Simply measured resources put into programmes - inputs. The level of service provided - output - takes account not only of resource inputs, but efficiency and effectiveness of their use. We are continuing to review and develop use of output measures in planning and management of public expenditure.

14. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

15. Cash limits 1982-83 and public sector pay?

(See K10-12).

16. 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. Provision for public service pay increases next year limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

#### LOCAL GOVERNMENT

17. Overspending in 1982-83? Government response?

Disappointed that preliminary figures show local authorities are budgeting to spend above Government's plans. Overspending particularly to be regretted since plans are realistic. Local authorities could achieve them if they try hard enough. Government's response to combat overspending will be announced shortly. Scottish Secretary has announced that he will seek to reduce the grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million). The authorities have only themselves to blame for these grant penalties. They can avoid them if they plan for more reasonable levels of expenditure.

18. Government's plans for later years are unattainable?

[Press reports have claimed that White Paper implies 9 per cent total reductions in 1983-84].

Government's plans for 1983-84 are fair and realistic - they are 4 per cent higher than for 1982-83. [IF PRESSED: if this means that LAs are faced with need to make substantial economies, reason will be LA's overspending in 1982-83].

19. Large rate increases this year are Government's fault?

Not at all. If local authorities had sought 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.

20. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of decrease in NIS. We are consulting local authorities about details. [NOT FOR USE: We are considering whether to reduce RSG or to leave NIS unchanged for local authorities in 1982-83.]

21. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

## F CIVIL SERVICE STAFFING AND PAY

[Functions being exercised by HM Treasury since 16 November 1981: (1) civil service manpower, pay and allowances, retirement policy and superannuation scheme, staff inspection and evaluation, (ie central allocation and control of resources), (2) responsibility for Central Computer and Telecommunication Agency and Civil Service Catering Organisation (3) civil service industrial relations. Functions being exercised by Management and Personnel Office (MPO): (1) civil service efficiency, personnel management, recruitment and training, (2) Office of Parliamentary Counsel (3) machinery of government questions.]

### 1. Civil Service too big/does too much/is over staffed?

Since the Government came to office, Civil Service has been reduced by nearly 8 per cent to 675,400. This is smallest for 15 years. This results from a reduction in functions, privatisation and improvements in efficiency. We are on course to achieve our aim of having a Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean the smallest Civil Service since the end of the war.

### 2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982. FT 30 April reports Government will implement award - worth 5.9 per cent overall - speculation.]

Negotiations failed. Matter referred to arbitration and heard by Civil Service Arbitration Tribunal on 19 and 20 April. Award made known 23 April. Government considering this, and will announce its decision on implementation as soon as possible. [NB: Announcement expected in week beginning 2 May.]

### 3. Civil Service pay: industrials

[Settlement date 1 July 1982]

Claim for increase in pay in line with inflation, a shorter working week and longer holidays, is under consideration.

### 4. Scott Report/Public sector pensions?

See K 18.

## G SOCIAL SECURITY

### 1. Now that unemployment benefit is to be brought into tax why not restore November 1980 5 per cent abatement?

Decision to abate UB was not simply taken as a proxy for tax but to reduce public expenditure and to improve incentives to find and keep work. (Chancellor's Budget statement in March 1980 made that perfectly clear.) Those reasons remain valid. Any improvement on rates announced would seriously worsen incentives. Cost too would be high - £60 million in a full year [net of reduced claims for supplementary benefit, but gross of tax].

### 2. Why cut child dependency additions to unemployment benefit?

[In line with practice in recent years, uprated level of child dependency additions to unemployment benefit (but not Supplementary Benefit) has been abated by amount of increase in Child Benefit. In consequence, CDAs will be reduced from current level of 80p to 30p next November.]

The child dependency additions to unemployment benefit are being phased out, and will eventually be replaced entirely by Child Benefit. In this we are following practice adopted by last Labour Government.

### 3. Increasing supplementary benefits by less than forecast movement of prices hits at poorest of the poor, and breaks an election pledge?

The benefits will retain their value in real terms. Beneficiaries receive not only their scale rate entitlement but a cash payment to cover their housing costs in full. By uprating scale rates in line with RPI which includes housing costs, there has been some double provision. The change corrects that. The abatement of  $\frac{1}{2}$  per cent represents a broadly based adjustment for the likely relative movement of housing costs to November 1982. [NOTE: we do not want to make public a forecast of a housing index.]

### 4. Death grant - increase to realistic level?

[Social Services Secretary on 3 March published consultative document about death grant, asking for comments by 30 July.]

Social Services Secretary would welcome comments on his recently published consultative document on death grant. As we have always made clear, our aim is to redistribute the resources now devoted to death grant in a more sensible fashion - we cannot afford to add to those resources.

## H PUBLIC SECTOR BORROWING

1. Why was such a serious error in forecasting the 1981-82 PSBR made so near to end of year?

[1981-82 PSBR estimated outturn published in 1982-83 FSBR £10.6 billion; April 1981 to March 1982 results reported in 22 April press notice £8.6 billion. Main causes of reduction from FSBR figure were reduction in central government own account borrowing of £1.3 billion and reduction in local authority borrowing requirement of £0.4 billion.]

Forecast based on best estimates at time of 1982-83 FSBR. Always considerable uncertainties at time of Budget. Spending, and some forms of borrowing, often high and variable in March. [IF PRESSED: Always difficult to predict end-year flows of expenditure and receipts, and effects of Civil Service dispute on monitoring added considerably to uncertainties at time of FSBR.]

2. How can the Government treat the PSBR as a crucial statistic when forecasting errors of this size occur?

Importance of balance between government's spending and income recognised by all governments, whatever the difficulties of forecasting.

3. Interest rates will now fall?

Not necessarily. Many factors involved in deciding appropriate level of interest rates.

4. Won't the PSBR in 1982-83 also be lower, and doesn't this cast doubt on the Budget judgement?

[1982-83 FSBR shows forecast 1982-83 PSBR of £9.5 billion.]

Too early to say until more detail is known on last year's income and expenditure flows. Possibility of some action on the fiscal front during 1982-83, depending on economic developments, made quite explicit in Budget speech. [IF PRESSED: Not necessarily true that 1982-83 PSBR estimate would have been different had more accurate 1981-82 outturn been available. Figure of £9.5 billion was judgement of what could be financed in market at tolerable interest rates in all circumstances of time.]

5. Implications for public expenditure in 1981-82 and 1982-83?

Not known exactly what 1981-82 outturn will be nor the implications for 1982-83, as will be some time before information on 1981-82 outturn will emerge. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from

## J MONETARY AND FINANCIAL POLICY

### 1. Effect of Falklands dispute on markets?

[Interest rates are fluctuating at levels about  $\frac{1}{2}$ - $\frac{1}{2}$  per cent higher than before the crisis. No sign of base rate moves.]

Markets uncertain, but initial shock seems to have been absorbed without significant ill-effect. Too early to say what long term effects will be, but Government determined not to be deflected from its path. Recent indicators good, eg RPI, money supply figures.

### 2. Prospects for Lower interest rates?

[Bank base rates reduced by  $\frac{1}{2}$  per cent to 13 per cent with effect from 12 March. Have come down by 3 per cent from peak of 16 per cent last autumn. Market rates are roughly  $\frac{1}{2}$  per cent higher than level just after Budget, largely in reaction to Falklands dispute].

Of course we want to see lower rates. Have seen significant reductions over past 6 months. But we must proceed cautiously if we are not to let up in the fight against inflation.

### 3. Will high and unstable US rates affect UK rates?

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background.

### 4. Falls in interest rates since New Year incompatible with strategy?

Taking account of all evidence, present levels of interest rates are consistent with policy of continuing downward pressure on inflation.

### 5. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time.]

No. Updated MTFS is realistic and flexible, describes how monetary policy operated in practice. MTFS serves useful purpose. Right to retain and adjust in light of experience.

6. Monetary targets discredited?

Monetary targets have important role in defining medium term direction of policy. But short term movements in monetary aggregates not always reliable guide to monetary conditions. Policy decisions based on assessment of all available evidence.

7. Overshoot of 1981-82 monetary target

[£M3 grew by 0.2 per cent seasonally adjusted in banking March; annual rate of growth since Feb 1981 (ie 1981-82 target period) 13.4 per cent; M1 fell by 0.7 per cent, 7.3 per cent since Feb 1981; PSL 2 rose by 0.6 per cent, 11.7 per cent since Feb 1981.]

Growth in £M3 was above top end of 1981-82 target range, even allowing for effects of Civil Service strike. At least part of excess reflects increasing market share of banks in mortgage lending. Also reflects longer term effects of institutional changes such as ending of corset, abolition of exchange controls and changes in savings behaviour. These factors imply higher monetary growth permissible for same increase in nominal incomes. [NB. Annualised rates of growth over 1982-83 target period on basis of one month's figures would not be sensible.]

8. Monetary conditions too tight?

Behaviour of exchange rate and money GDP as well as monetary aggregates suggest financial conditions have been moderately restrictive as intended. But bank lending still high, despite level of interest rates. Companies' financial position much stronger than a year ago. (See P3)

9. Bank lending

Still very strong. Part at least is substitution for lending by building societies and other forms of consumer credit. To extent that it is additional, adds to inflationary pressure, so must avoid premature relaxation of interest rates.



## K PRICES AND EARNINGS

### 1. Inflation still higher than when Government took office?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.1 per cent.]

Average level of inflation will be lower under this Government than under its predecessor. This will be the first Government since the war that has achieved a lower rate of inflation than its predecessor.

### 2. When will single figure inflation be achieved?

[Year-on-year rate of inflation 10.4 per cent in March compared with 11 per cent in February, and 21.9 per cent in May 1980.]

Budget forecast is for year-on-year rate of inflation of 9 per cent by Q4 1982, falling to 7.1 per cent by mid-1983. We expect rate of inflation to be below 10 per cent well before end of year. [NOT FOR USE: possibility April figure below 10 per cent.]

### 3. What reason is there to expect a further decline in inflation?

Over the next year or so, moderation in unit labour costs should continue to exert downward pressure on the rate of inflation, as should weak commodity prices. Competitive pressures on firms to limit price rises are also likely to remain strong.

### 4. FSBR inflation forecast more optimistic than major outside forecasts?

Assessments released since Budget expect single figure inflation to be recorded this year (LBS, NIESR, P&D, Simon and Coats, St James). March CBI monthly trends enquiry showed, for second consecutive month, substantial decline in net balance of firms expecting to raise prices in next four months [Dec and Jan 47 per cent, Feb 40 per cent, March 32 per cent].

### 5. Effect of 1982 Budget on RPI?

Compared with full indexation of excise duties, direct effect of Budget is RPI reduction of 0.1 per cent (or an increase of 0.1 per cent including also the direct effect of the 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 0.8 per cent increase in the RPI (or 1.4 per cent including also 2 December measures).]

### 6. Effect of 1982 Budget on TPI?

Compared with full indexation of excise duties, direct effect of Budget is TPI reduction of 0.4 per cent (or increase of 1.1 per cent including also direct effect of 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 1.6 per cent reduction (or a 0.3 per cent increase including also 2 December measures).]

7. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. But since middle of 1980-81, gap between NI price increases and RPI has narrowed. [See R12]

8. Current level of pay settlements?

In economy generally, settlements in last pay round averaged 8-9 per cent. Negotiators seem to be settling up to about a third lower in this round than they did in previous. And almost all settlements seem to be in single figures.

9. Private sector pay

[CBI figures suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

10. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

11. 4 per cent pay factor unrealistic/unfair?

Real incomes had risen to unsustainable level in recent years and public service pay increased relative to private sector since 1979. 4 per cent is broad measure of what Government thinks reasonable and can be afforded as general allowance in fixing the programme from which public service pay bill has to be met.

12. Nurses broken through the 4 per cent?

The 4 per cent factor is not a norm. Government recognises need for pay settlements to take account of market factors, including effect on recruitment and retention of expensively trained staff in NHS.

13. Civil Service pay?

See F2-3.

14. Average earnings index

[Year on year growth 11.3 per cent in February compared with 10.8 per cent in January, though (unpublished) underlying increase slightly less than in recent months at around 10½ 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 February straddles two pay rounds - not useful indicator of recent trends.

15. 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.

16. Movement in TPI

Fact that TPI has been increasing faster than RPI (roughly 3½ per cent faster over year to March 1982) reflects measures taken to restrain Government borrowing - essential if inflation is to be controlled.

17. Government aiming to cut living standards?

[Although RPDI was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

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.

18. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference 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.

19. Index-linked pensions and the Scott Report?

The Government is considering the whole question in the light of the Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

## L BALANCE OF PAYMENTS

### 1. Will the freeze on Argentine assets affect the standing of the City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe the international financial community will understand this.

### 2. Does the freeze involve reintroducing exchange controls?

No. We are denying Argentina access to her assets which is the reverse of traditional exchange control - which controlled payments by UK residents to non-residents.

### 3. Balance of advantage favours Argentina in mutual freezing of assets?

Argentine retaliation will not affect UK economy as a whole. Although UK assets in Argentina greatly exceed Argentine assets here their assets here are highly liquid. The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. At least two Argentine public foreign borrowing operations amounting to \$400 million have been suspended since the crisis began.

### 4. New Argentine financial restrictions?

[Reports that Argentina to issue dollar-denominated bonds to meet some current interest payments].

Payment to UK from Argentina already suspended by the Argentines. Reports are confused on details, but Argentina is clearly looking round for devices to avoid bankruptcy. Rest of world will draw their own conclusions about the credit-worthiness of the Argentine regime.

### 5. January trade figures

[Published 2 April]

Current account surplus in January estimated at £348 million, continuing the trend of strong surpluses. A visible trade deficit of £132 million was outweighed by projected invisible surplus of £480 million, swollen by EC budget refunds.

### 6. Exports

January export figures were erratically low, probably due to bad weather during first half of month. Necessary to wait for February figures for more accurate idea of recent export trends.

### 7. Imports

January import figures tend to confirm trend of last quarter 1981, reflecting increased demand for basic materials and other imports together with much less destocking.

8. Why is invisible surplus projection so high?

The projected invisibles surplus of £480 million takes into account further EC budget refunds of over £800 million in Q1 1982 (see N4). Earnings of overseas oil companies operating in the North Sea are likely to have been depressed, reducing debits on the interest, profit and dividends account.

9. Balance of payments Q4 1981

Current account established to have been £1,541 million in surplus in Q4, including a visible trade surplus of £623 million. Total 1981 current account surplus £8 billion.

10. Prospects for 1982?

[FSBR projects surplus of £4 billion on current account; average margin of error is £2 billion. Outside forecasts range from near balance to £7 billion surplus.]

Very uncertain, but nearly all forecasts see continued surplus - albeit below last year's record level.

## M EXCHANGE RATE AND THE RESERVES

### 1. Policy towards the exchange rate

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Recent lows were \$1.7470 on 6 April, DM 4.07 on 20 October. Highs were \$1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 29 April were \$1.7819, DM 4.199 and an effective of 89.43. Reserves at end March stood at \$19.0 billion, compared with \$23.4 billion under the old valuation at end February.]

The Government has no target for the exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy.

### 2. Effects of Falkland Islands dispute on sterling

Hardly surprising if the uncertainties had some unsettling effect. But markets are aware that the underlying position of the UK is strong, with inflation falling, growth picking up and a healthy balance of payments surplus. The Falklands dispute is small in relation to this overall macroeconomic picture, and there is no question of it requiring any change in our basic economic strategy.

### 3. Bank of England intervening to support the rate?

Policy is unchanged. The Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions are unsettled. But as the Chancellor has already stated we have no target - undisclosed, secret or otherwise - for the exchange rate.

### 4. Coordinated intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

### 5. Sterling should join the EMS?

[See N10-11]

### 6. Lower the exchange rate to help UK competitiveness?

Effective exchange rate is now about same as when Government came to office. So any loss of competitiveness since then is entirely due to our paying ourselves more than we can afford. Only way to achieve lasting gains in competitiveness is by cutting inflation and bringing costs under control.

7. Why has revaluation of reserves led to such a large fall?

[Revaluation reduced reserves from \$23.2 billion to \$19.0 billion, a reduction of \$4.2 billion.]

Because of the rise in the dollar since March 1981 the value of our non-dollar convertible currency holdings as expressed in dollars is less. At the same time the value of each dollar's worth of reserves is more. Similarly the dollar price of gold has fallen considerably in value over the past year. (Gold held in the reserves (other than that swapped for ecus) has been revalued at 75 per cent of the final fixing price on 31 March, according to the usual formula used in the annual revaluation.)

8. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to \$14 billion by end of 1981. This has been more than achieved - external debt is now around \$13½ billion, compared with over \$22 billion when the Government took office.

## N EUROPEAN MATTERS

## MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

Foreign Ministers continued their discussions at their meeting on 27 April. The Foreign Secretary impressed on our partners the need for a settlement which was fair for both Britain and the Community. There will be further contacts with the Presidency and the Commission in preparation for a further discussion by Foreign Ministers in the near future.

2. Link with CAP prices?

All member states agreed that the three chapters of the mandate (development of Community policies, agriculture and the Budget) must be taken together. The agricultural chapter and the budget chapter will therefore be carried forward in parallel.

3. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May 1980.

4. UK refunds in respect of 1981

Commission paid us before 31 March £813 million for supplementary measures as first instalment of our refunds in respect of 1981. This represents 81 per cent of our entitlement for that year. Our net contribution for 1981-82 is now put at some £200 million - very substantially less than it would have been without the 30 May 1980 budget agreement.

5. UK a net recipient in 1981?

[Commission's latest estimates suggest that we were small net beneficiaries in 1981]

On our figures, we remained a small net contributor to the allocated Community budget. We also, of course, contribute to aid etc. which is part of the unallocated budget. Very satisfactory that the outturn was better than expected: for we remain one of the less prosperous member states.

6. Will UK have to repay or forego refunds if net contribution less than originally estimated?

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



7. 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.

8. Policy for CAP reform

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

9. Costs of CAP to UK consumers

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

10. What is the current attitude of the UK Government?

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.

11. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

## P INDUSTRY

1. Budget does not do enough for industry?

Budget measures directed at helping business and will cost £1 billion in 1982-83. On indexed basis over 2/3 of Budget's net revenue cost will go to help businesses. But main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates.

2. Prospects for industry-recovery?

Fall in output has now come to an end. Industrial production in Q4 1981  $\frac{1}{2}$  per cent up on Q3 and some 2 per cent up on H1. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole. March CBI enquiry and FT opinion survey encouraging (see B3).

3. Company financial position?

[Non-oil industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation) rose by over a quarter between 1H and 2H 1981, but from a very low base - ICC's real rate of return just  $2\frac{1}{2}$  per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

	1979	1980	1981 Year	H1	H2	£ bn
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	
Financial surplus (+)/deficit (-)	-2.7	- 1 $\frac{1}{2}$	+1.2	+1.5	-0.3	]

Increase in profits (albeit from low level) encouraging. Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years.

4. Rate of return still too low?

[Real pre-tax rate of return of ICCs was  $2\frac{1}{2}$  per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

5. High 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.]

Budget measures have eased pressure on interest rates, and the recent  $\frac{1}{2}$  per cent fall in the banks' base rates is encouraging. But 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. Continuing relatively high level of 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 J).

6. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme this year (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

7. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 3,350 guarantees - about half to new businesses. Total lending under scheme is just under £114 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million will be made available in following year. Three more banks admitted to scheme in April making total of thirty financial institutions now participating.

8. Progress with setting up Enterprise Zones?

Excellent progress being made. All of eleven zones now in operation, following designation of final zone - Isle of Dogs - in April.

9. Response from private sector?

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.

## R NATIONALISED INDUSTRIES

### GOVERNMENT RELATIONS WITH NATIONALISED INDUSTRIES

[Industry Secretary announced 15 March that Government is to change its dealings with nationalised industries by agreeing objectives with each, putting more emphasis on efficiency by increasing Monopolies and Mergers Commission references and through board structures, and by strengthening business expertise in Whitehall.]

#### 1. Whitehall making a take-over bid for the industries?

Monitoring not same as interference in management. Crucial for officials and Ministers to be informed about the industries' progress and about any problems that arise; no intention to interfere with proper role of management within the industries.

### EXTERNAL FINANCING LIMITS

#### 2. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes), £1.7 billion in 1983-84, £1.2 billion in 1984-85 - a total of over £4 billion over the three years of the Survey. Government has given full recognition to problems faced by the industries in a period of recession. Increase in 1982-83 was roughly half what the industries bid for.

#### 3. Unreasonable to reduce EFLs following NIS cut?

Reduction in the National Insurance Surcharge was designed to benefit private sector; not the intention that public sector should gain from it. Amendments to EFLs announced 7 April are offsets to the addition to the industries' internal resources that would have followed the NIS cut. No industries will be worse off than previously, and their plans should be unchanged.

#### 4. Pay assumptions?

Government has not set pay or any other assumptions for the industries. Moderate pay settlements - and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

## INVESTMENT

5. How robust are the forecasts of nationalised industry demand/contributions to public expenditure, given the recent track record?

Plans published in PEWP at Budget time considerably less optimistic than those published last year. In particular, in increasing substantially the external finance available to the industries in each year of the Survey, Government recognised effect of lower demand on the industries' internal resources - now expected to be well below the levels in last year's White Paper (by about £2 billion in each of the years 1982-83 and 1983-84). The industries' external financing needs still expected to decline over Survey period, but from higher base and at more gradual rate than forecast last year.

6. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in White Paper are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

7. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £ $\frac{1}{4}$  billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been cut in investment in response to changed circumstances such as lower market demand. These cuts have been extraneous and have not borne any direct relationship to EFL pressures. Other cuts have been for wholly beneficial reasons, such as lower than expected inflation and cost savings.

8. Take nationalised industry investment out of PSBR?

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

9. Private finance for NI investment?

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

We have indicated willingness to consider new financing proposals. Direct market finance can only be justified if there is genuine element of performance-related risk for investors, in order to improve incentives to management efficiency, and if new forms of saving are

tapped, to avoid adverse monetary consequences. Market financing does not of itself lessen burden on financial markets.

10. Does Government propose to sell shares in BT?

Recent press reports are speculative. As the Chancellor announced in Budget statement, detailed work is proceeding on 'Buzby bond'. Government continues to examine ways in which market pressures could be brought to bear on nationalised industries, including BT.

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

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

#### NATIONALISED INDUSTRY PAY AND PRICES

12. Nationalised industries' prices

[March figures: RPI up 11.4 per cent, NI component up 11.5 per cent.]

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint between 1974 and 1980. But since middle of 1980-81, gap between NI price increases and RPI has narrowed. Artificial price restraint would result in unacceptable increased burden on taxpayer and distortion of market forces.

[CAUTION: gap between NI and 'all items' RPI could widen again in near future. Factors include LT fare increases in spring, winter electricity discount scheme ending, dropping out of RPI of last year's double revalorisation of excise duties.]

#### PRIVATISATION

13. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

14. Net figure for special asset sales this year?

[Public Expenditure White Paper showed net sales of only £50 million in 1981-82; latest estimate included in FSBR is -£100 million - ie £100 million net purchases.]

Low net figure is result of decision not to proceed with further programme of advance oil sales in weak market. Gross figure expected to be in line with £500 million target included in last White Paper; will include proceeds from Cable & Wireless, sale of Amersham International Limited and National Freight Company Limited, sale of Government's shareholding in British Sugar Corporation, and further sales of motorway service areas long leases.

15. 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 any future borrowing by these undertakings be outside the PSBR, so reducing burden on taxpayers, but the organisations concerned will be made more responsive to market forces and thus have greater incentives to improve efficiency.

16. Government running into heavy weather over sale of Wytch Farm?

The British Gas Corporation is proceeding with arrangements for sale of the Government's interest in Wytch Farm. It is too early to say when the sale will take place.

17. Government has sold assets too cheap? (PAC criticisms)?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices where shares first traded. PAC report published 28 April criticised handling of British Aerospace sale.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares. Hon members will have to wait for formal Treasury Minute responding to PAC report.

## S NORTH SEA AND UK ECONOMY

### 1. In view of recent falls in price of oil, why did HMG not reduce tax burden on North Sea oil producers?

[Budget tax changes included abolition of Special Petroleum Duty, increase in Petroleum Revenue Tax rate from 70 per cent to 75 per cent, and new system for advance payments of PRT (all from 1 January 1983), plus smoothing of PRT payments from July 1983 (this improves HMG's cash flow at companies' expense). Changes reduce the marginal rate of tax (from 90.3 to 89.5 per cent); involve slight fall in Government 'take' (no change 1982-83, costs £70 million 1983-84).]

Recognise need for tax structure robust to both falling and rising prices. Detailed study showed us that under new structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new tax structure will provide more secure and stable regime.

### 2. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system].

Other adverse factors - falling oil prices; high development costs - much more important. No evidence that tax system alone is inhibiting future development.

### 3. Government has missed opportunity to simplify North Sea fiscal regime?

The oil industry has made it clear that it would not welcome a structural upheaval. Would create serious uncertainty and major transitional problems.

### 4. Impact of falling oil prices on Government revenues and Government strategy?

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. Treasury has estimated that each \$1 off the price directly reduces revenue, other things being equal, by £250 million in first year and £350 million in full year. Chancellor warned in his Budget statement he could not rule out possibility of having to take action to correct the fiscal balance if there were to be a marked and prolonged fall in oil prices. But falling world oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation.

### 5. Implications of OPEC production limitation agreement for North Sea oil prices?

Remains to be seen whether the agreement will hold, and whether world oil prices will harden as a result.



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

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections already incorporate fall to \$31 a barrel for Forties oil. Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

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. Less than 6 per cent of total General Government receipts in 1981-82.

7. 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.

8. 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.

9. Are we really any better off for our North Sea Oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared the fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil is costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for the possession of oil to require a contraction in our industrial base.

## T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

### 1. Government will have no choice but to reverse policies now unemployment has risen to post-war record levels in many Western countries?

Unadjusted unemployment exceeded 10 million in USA and 1 million in Canada in January. It exceeded 2 million in Italy in September, 2 million in France in October, and 1.9 million in Germany in February. Highest ever unemployment levels in Canada, France, Italy and UK and highest in USA and Germany since the War.]

No indication of a widespread departure from consensus achieved last year (eg Ottawa Summit, IMF Interim Committee) about need for prudent fiscal and monetary policies to bring down inflation.

### 2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 8.5 per cent in February. Underlying rates falling in US. 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: some 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. Other countries giving priority to reducing 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.

### 5. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has used its special powers to freeze prices temporarily and severely curtail wage increases for rest of 1982.]

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.

6. UK is alone in Europe. Even Germany announced investment/employment scheme?

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. Netherlands has just agreed to measures which will reduce PSBR by about 0.9 per cent of GDP below what it otherwise would be. French government has set limit on its budget deficit for 1983 of 3 per cent of GDP. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

7. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasters expect UK growth this year of about 1½ per cent rising to an annual rate of 2 per cent by early next year. This is very closely in line with the OECD's forecast for OECD Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. Prospects for US economy?

[In March US industrial production fell 0.8 per cent, to 8.3 per cent below July's peak; February's rise was shown to be a statistical blip on the chart and on 17 April Treasury Secretary Regan pronounced the economy 'dead in the water'. Seasonally adjusted unemployment is now 9 per cent of the labour force. Inflation fell for the 5th consecutive month to 7.6 per cent in February.]

Continued decline in inflation is good news; wage settlements in which unions have given job security priority over wage increases are contributing impressively to this decline.

9. US Budget compromise?

[Discussions continue: extra revenue proposals include 4 per cent supertax on incomes over £22,000, higher taxes on tobacco, liquor and oil imports; unspecified cuts in planned defence and Social Security spending also mooted.]

Firm monetary policy needs to be backed up by tighter fiscal policy. Hope that Congress and Administration soon reach an agreement that will reduce federal deficits and uncertainty in the financial markets. High US interest rates in no-one's interest.

10. Recent international interest rate developments?

True that US interest rates rose earlier this year. But prime rates are well below their peak of 21½ per cent last summer (currently 16½ per cent)

11. Prospects for international interest rates?

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

12. OECD forecast leaked?

[Some OECD forecasts on the world economy have been leaked to The Times which published them on 23 April, with one misprint.]

Can neither confirm nor deny accuracy of press report of unpublished forecast by OECD. OECD's twice-yearly Economic Outlook still being prepared; not due to be published until July.

## PRESENT SITUATION

Clearly a range of outside forecasts; from ITEM and CEPG the more pessimistic to Liverpool more optimistic. Most major post-Budget assessments (LBS, NIESR, St James, P&D, St J) judge impact of Budget and falling oil prices favourable. Output by those groups forecast to grow about 1½ per cent in 1982 (cf FSBR's 1½ per cent), inflation to fall to single figures by end 1982 (cf FSBR's 9 per cent in 4Q 1982); very much in line with FSBR. CEPG broadly in line on inflation prospects, but see little prospect of any growth in output in 1982 or 1982. All groups expect continued rise in unemployment (UK adult sa) during 1982 to around 3 million. Forecasts for 1983 vary, from some groups expecting further rise (CEPG, NIESR, ITEM) to others (P&D, Simon and Coates) expecting some slight decline (roughly 50,000-100,000) and Liverpool expecting fall of 400,000.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. Recent months' industrial output figures affected by bad weather, car and rail strikes. Nevertheless, Q4 1981 manufacturing output some 2-3 per cent above low point in Q1 1981.

Consumers' expenditure was unchanged in Q1 1982: continuing the flat trend of the last 2-3 years. Retail sales in Q1 1982 rose 1 per cent returning to the level of a year ago. The volume of visible exports in the last few months of 1981 were high compared with the level earlier in that year but there was a sharp drop in this volatile series in January 1982. Latest evidence indicate that there has been a significant rise in the volume of visible imports since the middle of 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 a fall of about 5 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 £25 million (at 1975 prices) in Q4 1981 the smallest quarterly fall in the last two years of continuous destocking.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,850,400 (11.9 per cent) at April count, up 28,000 on March. Vacancies were 109,600 in April.

Wholesale input prices (fuel and materials) fell 2 per cent in March causing the year-on-year increase to dip to 8 per cent. Wholesale output prices rose ½ per cent in March but fell to 9½ per cent above a year ago. Year on year RPI increase fell to 10.4 per cent in March. Year-on-year increase in average earnings was 11.3 per cent in February. RPDI was flat in

the last three quarters of 1981; it fell 2 per cent between 1980 and 1981 after rising 17 per cent between 1977 and 1980. The savings ratio fell 0.7 points to 13.1 per cent in Q4 1981.

PSBR £8.6 billion and CGBR (unadjusted) £7.6 billion in the financial year 1981-82 but both distorted by the effects of the civil service dispute.

In banking March Sterling M3 and PSL1 both rose 0.2 per cent while PSL2 rose 0.6 per cent and M1 fell by 0.7 per cent.

Visible trade has showed a surplus of £0.5 billion on the 5 months from September 1981. Current account surplus over same period of £2 billion and likely surplus in 1981 as a whole £8 billion. UK official reserves following revaluation were \$19.0 billion at end-March. At the close on 29 April the sterling exchange rate was \$1.7955 while the effective rate was 89.7.