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 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 17 May, are sidelined. Questions and answers on the impact of the Falklands crisis will be found in Section U.

M M Deyes

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RA

R I G ALLEN

24 May 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. 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.

3. 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 some recovery in profits and rather stronger financial position of industrial and commercial companies. (See also Section P).

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

See Section D.

5. Lower than forecast 1981-82 PSBR means fiscal policy tighter than intended?

[PSBR outturn 1981-82 £8½ billion (22 April press notice), PSBR forecast at time of Budget March 1981 and still predicted in 1982 PSBR was £10½ billion]

Not possible to answer this question until more known about why PSBR was lower in 1981-82. Need also to consider the wider context. Lower borrowing by public sector in first quarter of 1982 was factor in sharp fall in our interest rates in those months - at a time when overseas interest rates generally were not falling.

6. 1981-82 PSBR outturn inconsistent with MTFS?

Misleading to look at PSBR for individual years in isolation. Government's aim remains to reduce PSBR as ratio of GDP over medium-term. The estimates for outturn in 1981-82 suggest that ratio in that year was about 3½ per cent, similar to ratio planned for this year. But looking over a longer run of years the trend is clearly downward.

7. Scope for autumn Budget tax cuts/revised PSBR for 1982-83?

[Views of James Capel reported Guardian 17 May].

Crucial judgement is what PSBR would be consistent with Government's objectives for reducing monetary growth and inflation at acceptable interest rates. Cannot assume that shortfall in 1981-82 PSBR will necessarily feed across to 1982-83: far less that Budget judgment needs revision. Always a great number of uncertainties about economic and financial developments both at home and abroad - and, as Chancellor indicated in Budget Speech, we shall keep development of fiscal policy under close review. (See Section H for further material).

8. Government's impact on inflation disappointing?

[April RPI figure published 21 May].

12-monthly RPI inflation rate now $9\frac{1}{2}$ per cent - down from $10\frac{1}{2}$ per cent in March. Lowest figure for over three years. Then, inflation was accelerating. Now, the trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982.

9. Economic recovery in doubt?

[March industrial production figures, published 18 May, show only relatively modest recovery from strikes/severe weather affecting December/January levels; industrial production still at broadly same level as last autumn. GDP(O) figures for Q1 1982, published 20 May, show $\frac{1}{2}$ per cent fall on Q4 1981.]

Profile of recovery likely to be uneven and jerky particularly when affected by such factors as very severe weather and industrial disputes. It remains the case that activity is above levels of last spring. Prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators (latest published 21 May) and business opinion survey. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See also Section B.)

10. Investment remains depressed?

[1982 Q1 figures for capital expenditure in manufacturing, distribution and services sector published 20 May; new DOI Investment Intentions Survey due to be published 27 May.]

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has remained level into Q1 of this year following sharp falls from Q4 1979; intentions surveys point to some recovery in course of 1982. Strong growth in distributive and service industries investment - up $12\frac{1}{2}$ per cent since Q1 1981.

11. Do FSBR forecasts still hold?

No reason seriously to question broad shape of forecasts but in certain areas, eg inflation, we could well make faster progress than foreseen at Budget time. (Not the practice to issue

revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.)

12. Outlook for unemployment?

[Warwick University group see level continuing at 3 million to end of decade: report in FT 24 May.]

Not the practice to publish estimates of the overall effects of the Budget, or its individual measures, on employment. But current policies to tackle inflation provide only basis for sustained recovery and more jobs. (See also Section C)

13. Armstrong/unified Budget?

Await TCSC report with interest. Proposals need careful consideration. But Government does already take account of tax and expenditure when taking decisions on each.

14. Treasury model of economy 'rigged' to produce discouraging results from running unfavourable to alternative policies?

See Section P.

15. SSRC Modelling and Forecasting Consortium

[SSRC announced 18 May, on behalf of Consortium, decisions on funding of macro-economic modelling for period 1983-87. Funds available total about £ $\frac{1}{4}$ million a year, allocated to groups including NIESR, LBS and Liverpool, of which one-fifth will come from Treasury. Consortium also considering establishment of SSRC Centre for research into macro-economic modelling, but no decisions yet.]

Questions on allocating awards between different forecasters not for HMT to answer. But Consortium seems to have done difficult task well. [NOT FOR USE: Avoid comment on TCSC request for House of Commons to provide funds for Consortium or Centre: HMT privately unenthusiastic about this.]

16. Falklands crisis effects?

See Section U.

- (i) Activity recovered since last Spring. Most recent major independent forecasts business surveys and cyclical indicators see the prospect of further recovery in 1982. CBI survey (April) shows higher confidence and improved expectation of higher output and orders in next four months.
- (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 12 per cent since end 1980. Output per head and output per hour 5 and 8 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 Q1 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 lowish recent months figures have undermined earlier favourable comparison - non oil exports Sept '81 to Feb '82 up by less than 1/2 per cent on 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 1/4 that of a year earlier. Vacancies improved since mid 1981. Short-time working in manufacturing reduced by over 1/2'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. 12 monthly RPI increase in single figures in April (9.4 per cent); lowest since January 1979. Trend now clearly downwards, not upwards as then. Increase in RPI more than halved since peak (21.9 per cent) in Spring 1980. CBI April survey shows lowest degree of unit cost pressure for 15 years.
- (xiii) Examples of export successes reported in the Press include: design supply and installation over 300 miles of railway of carrier and audio telecommunications cable for Zimbabwe's railway electrification programme (BICC Telecommunications, Merseyside); contract for converting to leadfree petrol consumption of first 1000 BL Minis destined for Japan (Carbodies Ltd, Coventry).
- (xiv) 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.
- (xv) Overseas debt repayments. Official external debt reduced from over \$13.3 billion at end-1981.
- (xvi) 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 figures not encouraging?

[GDP(O) is provisionally estimated to have fallen slightly (about $\frac{1}{4}$ per cent) in Q1 1982, but remains $\frac{1}{2}$ per cent up on Q2 1981. Some stockbuilding in manufacturing and distributive industries in Q1 1982 following sharp slow down in rate of destocking in H2 1981. (First stockbuilding for two years). Volume of investment in manufacturing, distributive and service industries some 5 per cent higher in Q1 1982 than average for 1981].

Latest figures not uniformly unencouraging. While disappointing that rise in activity did not continue for third consecutive quarter, not unexpected that profile of recovery be uneven and jerky, particularly when affected by such factors as very severe weather and industrial disputes. Remains case that activity is above levels of last spring. Latest (20 May) figures also show rise in investment and also some stockbuilding during first quarter.

The prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators, and business opinion survey indicators. Most encouraging pointer to sustainable recovery is the continued progress against inflation.

2. April CBI Survey gloomy?

[Report in FT 6 May quotes Sir John Cleminson, chairman of CBI economic statistics committee, as saying that latest Survey 'does not support some of the more optimistic statements which Treasury Ministers have made about the prospects of recovery'. CBI commentary and their spokesman's remarks, in common with past experience, not helpful.]

Survey shows improved business optimism, and improved prospects for output, orders, inflation and company liquidity. These are certainly consistent with - and indeed support - view taken by Chancellor at Budget time of further recovery and falling inflation during 1982.

3. Other evidence of improvement in economy?

See Bull Points (following Section A).

4. 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	1 $\frac{1}{2}$	2
Manufacturing output	3	2
Consumers expenditure	$\frac{1}{2}$	$\frac{1}{2}$
Investment (private sector and public corporation)	4 $\frac{1}{2}$	5
Exports	3 $\frac{1}{2}$	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 ($7\frac{1}{2}$ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

5. Outside forecasts

[GDP profile in major post-Budget assessments:

	<u>NIESR</u>	<u>LBS</u>	<u>St James</u>	<u>Phillips & Drew</u>	<u>CEPG</u>	<u>FSBR</u>
	(Apr)	(Apr)	(Apr)	(May)	(April)	(March)
Per cent change 1982 on 1981	$+1\frac{1}{2}$	$+1\frac{1}{2}$	$+1\frac{1}{4}$	$+1\frac{3}{4}$	$-\frac{1}{2}$	$+1\frac{1}{2}$

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 8-9 $\frac{1}{2}$ per cent by Q4 1982 - also in line with FSBR. [See also C3 (unemployment), K3 (inflation) and L6 (balance of payments).]

C LABOUR MARKET

1. Recent unemployment figures?

[N.B May unemployment figures to be released Tuesday 25 May. Separate briefing will be supplied to No.10. In April, unemployment (UK adult seasonally adjusted) rose by 28,000 to 2,850,000 (11.9 per cent). 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. Increase in first four months of 1982 approximately one quarter that in same period 1981.

2. Vacancy figures disappointing?

[NB: May vacancy figures to be released Tuesday 25 May. Separate briefing will be supplied to No.10. In April, vacancies (UK seasonally adjusted) fell slightly for second consecutive month to 110,000 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. 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 $\frac{1}{5}$ 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.

4. 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; depends on so many factors. Following well-established precedent of previous administrations in 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. Greater the progress that can be made in reducing inflation and maintaining moderation in pay settlements, the better the prospects for unemployment.

5. 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 C1-3 above).

6. Unemployment higher than in other countries?

[On standardised definitions in Q3 1981 UK employment was 11½ per cent compared with 6¼ 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.

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

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

No 'right' figure for cost per additional person, or cost per additional 100,000 unemployed. Possible to produce wide range of estimates depending on assumptions made and concepts followed. No single figure of this kind can purport to show how changes in unemployment alter the public finances. [IF PRESSED on cost of benefit payments, rebates and administration only in current year: It is estimated that the 1982-83 cost of benefit payments, rent or rate rebates, and administration per extra ^{10,000}~~100,000~~ unemployed is around £18 million. [Answer given to PQ 13 May col W314.] IF PRESSED on total Exchequer cost: Estimates have been made of Exchequer cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). There has been continued work on the various elements included in that calculation. Treasury at present considering basis on which estimates of Exchequer cost prepared.]

8. What is Government doing to provide more jobs?

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 MSC working on proposed new non-profit-making scheme announced in Budget Speech.

9. Government reaction to MSC Task Group report on future of training for young people?

Task Group's proposals are of considerable significance for future shape of training arrangements for young school leavers, both employed and unemployed. Government will consider recommendations carefully with a view to reaching a decision as soon as possible this summer.

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 in 1982-83 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?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 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 lower than forecast (see A7). 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. Poverty trap/unemployment trap getting worse?

[Joint (Treasury/DHSS/Inland Revenue) memorandum submitted to TCSC Sub-Committee.]

The poverty and unemployment traps are a matter for concern. Must be remembered that result from attempts to relieve poverty over a period of years when the economy has shown little growth. The answer is to get sustained growth going again - this is the objective of our economic policies.

9. Budget reduction in NIS not enough for 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).

10. 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.

11. Government take from North Sea oil too high?

See S1.

12. Merger of tax and social security planned?

See G5.

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.

3. 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.

4. 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 MTFS 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.

5. 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).

6. 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.

7. 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.

8. 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.

9. 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.

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

(See Sections F and K.)

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. Provision for public service pay increases 1982-83 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.

12. Falklands effects?

See Section U.

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend.

Action in ENGLAND: Secretary of State for the Environment intends to implement scheme for grant abatement announced last year and is considering further across-board grant cut.

Action in SCOTLAND: Secretary of State for Scotland is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million).

Action in WALES: Secretary of State for Wales has announced his intention to withhold grant. He also asked Welsh local authorities to submit advanced budgets. Amount of grant to be withheld will be determined in light of these.

Local authorities have only themselves to blame for these grant penalties.

14. 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.

15. 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 aware of the difficulties

involved in offsetting the reduction by a decrease in grant, and are looking constructively at possibility of postponing the reductions for local authorities until April 1983.

16. 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, 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 Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having 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 Second World war.

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government announced on 6 May its decision to accept the award. Increases (announced 12 May) for the higher civil service (under-secretary and above) are larger; they have been decided in the light of the recommendations of the Top Salaries Review Body. Cash limits and manpower targets are not being adjusted. (See also Section K)

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

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

4. Scott Report/Public sector pensions?

See K 21.

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 not simply taken as proxy for tax but to reduce public expenditure and 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 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 (not Supplementary Benefit) abated by amount of increase in Child Benefit. In consequence, CDAs will drop from current level (80p) to 30p next November.]

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?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

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

5. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

H PUBLIC SECTOR BORROWING

1. Reasons for PSBR undershoot in 1981-82?

Reasons not yet fully understood, since information on borrowing comes earlier than information on the flows of expenditure and revenue that give rise to that borrowing. Budget 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. We shall certainly study reasons for shortfall and see what lessons they hold.

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

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

3. Implications for fiscal policy and MTFS?

See A5-7.

4. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 ie around $3\frac{1}{2}$ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

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 £105.2 billion in the FSBR to around £104.5 billion (around £104 billion was provisional estimate given in other briefing) and that ratio of public expenditure to GDP will fall from 45 per cent to $44\frac{1}{2}$ per cent].

6. Implications of CGBR outturn in April for year 1982-83?

[CGBR for April published last week £0.8 billion, compared with £2.4 billion in April 1981.]

Too soon to make any change in forecast for year on basis of only one month's figures. Last year's figures distorted by Civil Service dispute.

7. Effect of Civil Service dispute on PSBR?

PSBR in both 1981-82 and 1982-83 affected by Civil Service dispute. In 1981-82 some £ $\frac{1}{2}$ billion of receipts delayed from March 1981 were collected, but some £1 $\frac{1}{2}$ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £ $\frac{1}{2}$ billion in 1981-82.

8. Fiscal policy should be based on cyclically adjusted/real PSBR?

Some merit in inflation-adjusted measure as indicator of fiscal stance in some circumstances. But there are dangers here: it would be quite wrong to expand PSBR in cash terms in response to an upsurge in inflation merely to keep inflation-adjusted measure constant. Policies intended to eradicate inflation, not to adjust to it.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83

[In banking April (second month of target period) £M3 and PSL2 provisionally estimated to have increased by $\frac{1}{2}$ per cent and $1\frac{1}{4}$ per cent respectively; M1 to have been flat (all seasonally adjusted). Target range is for annual rates of growth of 8-12 per cent.]

Too early to judge outturn with any greater precision than at Budget time. But recent figures encouraging.

2. 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 P4)

3. 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.

4. 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. Markets seem to have absorbed impact of Falklands crisis without significant ill-effect.]

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.

5. 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. (See also T10.)

6. Falklands crisis effects?

See Section U.

7. 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.

8. 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.

9. 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.

10. Overshoot of 1981-82 monetary target

[£M3 grew by 13.0 per cent per annum in 1981-82 target period compared with target range of 6-10 per cent; M1 grew by 7.2 per cent per annum, and PSL 2 by 12.1 per cent per annum over same period.]

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.

BUILDING SOCIETIES

11. Increase in special advances limit (from £37,500 to £60,000)

Should not mean any reduction in availability of loans for first time buyers. Building Societies Association have provided assurance that no society intends to reduce its lending at the lower end of the market. Limit essentially for prudential reasons.

12. Rights of Building Society Members

[Chancellor told BSA 18 May that management of some building societies 'too fearful' of democratic process].

Chancellor's remarks intended to be constructive. Building societies are mutual organisations. Must therefore be seen to uphold rights of members.

K PRICES AND EARNINGS

PRICES

1. Inflation lower than forecast in Budget statement?

[12 monthly rate of inflation 9.4 per cent in April, compared with 10.4 per cent in March and 21.9 per cent in May 1980. Budget forecast: 9 per cent by Q4 1982, falling to 7½ per cent by mid-1983].

Inflation is now in single figures and is continuing to fall. We could well make rather faster progress in reducing inflation than we anticipated at the time of the Budget.

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

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

3. FSBR inflation forecast more optimistic than major outside forecasts?

All assessments released since Budget contain an improved inflation prospect. April CBI quarterly survey shows substantial decline in net balance of firms expecting higher prices and costs in next four months. Balance of firms expecting higher costs now lowest for 15 years. (See also 1 above and A.11).

4. Inflation still not down to 7.4 per cent reached under previous Government?

[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 14.4 per cent.]

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts average level of inflation will be lower under this Government than under its predecessor - first time this has happened in over 30 years.

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. Movement in tax and prices index?

[Increase over 12 months to April 9.7 per cent, compared with increase of 9.4 per cent in RPI].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

7. 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).]

8. Nationalised industry prices

[Increase over 12 months to April 14.1 per cent, compared with an increase of 9.4 per cent in the RPI].

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played an important part. These increases are regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

9. Effect on retail prices of EC farm price settlement?

[EC Agriculture Ministers agreed on 18 May, by majority decision, to raise level of farm support prices under CAP by average of just over 10 per cent].

Estimates of effect of the CAP price settlement on retail prices can only be made in general terms, and will depend on such factors as the type of support operated and the prevailing market conditions in the sectors concerned. Agriculture Minister (in statement to House 19 May) estimated that total package would add in full year about $\frac{1}{4}$ per cent to retail prices index and $1\frac{1}{4}$ per cent to retail food price index. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

10. Current level of pay settlements

The recent decisions on public service pay which the Government has announced confirm the downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

11. 4 per cent pay factor abandoned?

The 4 per cent factor is not a pay norm, but a broad measure of what Government thinks reasonable and can be afforded in fixing provision from which public service wage bill has to be met. Government has decided to accommodate cost of Civil Service arbitration award within the relevant provision. Only if exceptional difficulties arose later in the year would limited calls on the contingency reserve be considered.

12. But doctors, dentists, armed forces have also had more than 4 per cent?

Part of cost of Government's proposals for doctors and dentists will be met within existing provision, and part from contingency reserve. Financing of the AFPRB award will be decided when current uncertainties about the defence budget have been resolved.

13. Government norm now 6 per cent?

There is no norm, nor has there been. The 4 per cent factor remains the basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned and partly from contingency reserve.

14. Government satisfied with 6 per cent?

Increases of 6 per cent are higher than provision which the Government made for pay within programmes. They will have implications for level of non-pay expenditure.

15. Why only 4 per cent for NHS ancillaries and white collar grades?

Cost of the Civil Service arbitration award will be accommodated within 4 per cent pay provision. Moreover, within the range of pay increases announced both for the Civil Service and the Armed Forces, many civil servants and Servicemen will get only a little above the 4 per cent being offered to some NHS groups.

16. Top Salaries Review Board increases too large compared with, eg, 6.4 per cent for nurses

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

17. Why only 4 per cent for MPs (also announced 12 May)?

Problems of recruitment, career structure and differentials do not apply to MPs. Government therefore felt is appropriate to propose increases no higher than the pay factor included in Estimates.

18. Average earnings index

[Year on year growth 11.0 per cent in March compared with 11.4 per cent in February, though (unpublished) underlying increase slightly lower than in recent months at around 10½ per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to March straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

19. Government aiming to cut living standards?

[Although RPD1 was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

No. 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.

20. 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.

21. 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. February trade figures

Current account surplus in February estimated at £ 664 million - largest monthly surplus since normal processing of trade figures resumed last September. Visible trade surplus was £174 million, and projected invisible surplus of £480 million reflected EC budget refunds of around £800 million in 1982 Q1.

2. Exports

Exports partially recovered from fall in January, and continue above level of a year earlier in volume terms. Export of oil and consumer goods (other than cars) were notably strong.

3. Imports

Import volumes of finished manufactured goods were 6 per cent lower in January and February than in 1981 Q4. However imports of basic materials have risen slightly over this period. This suggests that domestic industry is using materials at much the same rate as in 1981 Q4 but that UK manufacturers are now being more successful in the home market.

4. UK competitiveness

Most recent IMF figures show UK relative export prices are now no more than 5 per cent above the level of Q2 1979. And export prices (excluding oil) have risen only 1 per cent in the four months to February. On cost competitiveness IMF figures for actual relative unit labour costs show a 14 per cent improvement between Q1 and Q4 1981.

5. 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 N5). 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.

6. 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.

7. 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.]

Nearly all forecasts see continued surplus - albeit below last year's record level.

8. Falklands crisis effects?

See Section U.

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 4.098 on 21 May. Highs were \$1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 21 May were \$1.7975, DM 4.136 and an effective of 89.12. Reserves at end April stood at \$18.159 billion, compared with \$19.0 billion at end March.]

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. Falkland crisis effects

See Section U.

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. Concerted 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. 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.

6. 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'

At Foreign Ministers meeting on 16 May, the Commission proposed one-year solution to UK budget problem, as provided for in original 30 May 1980 agreement. Although we would prefer a longer-term solution and continue to press for such a solution before the end of the year, we agreed to consider a one-year solution for 1982 alone. Certain features of Commission's proposal did not in our view conform to the 30 May arrangements, so we put forward our own proposal. [Foreign Ministers continued their discussions on 24 May].

2. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement last week, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional and other issues which the Government is considering very carefully.

3. What level of contribution would HMG consider fair?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

4. Net UK contribution to community too high?

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

5. 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.

6. UK a net recipient in 1981?

In fact 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.

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

No. 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.

8. 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.

9. Policy for CAP reform

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

10. 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

11. 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.

12. 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. Treasury simulations for April meeting of NEDC: TUC accusation that Treasury 'rigged' results, on Chancellor's orders.

No truth whatsoever in this charge. Treasury model is designed, operated and, where necessary, modified, purely on basis of professional judgement of economists within Treasury. Treasury Ministers ⁱⁿ no way involved in its design or operation. (TUC charges were fully answered in a detailed statement issued by the Treasury on May 14.)

2. Will technical discussions between Treasury and TUC (and other NEDC partners) now take place?

We hope so (but no date has been fixed).

3. Prospects for industry-recovery?

Fall in output has now come to an end. Underlying level and manufacturing output now (ie February/March) about 2 per cent above level last spring. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole. Latest CBI survey encouraging (see B2).

4. 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 2½ 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	- 1½	+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.

5. Births and deaths of firms

[Report in FT 11 May of Henley Management College Paper showing 'more firms now dying than being born?']

No really satisfactory statistics to measure this. Henley used lists of firms registered under Companies Acts - not same thing as list of actively trading companies (eg sole traders and partnerships excluded, firms sold in liquidation to other companies counted as 'deaths'). A better guide might be the list of 1.3 million firms registered for VAT: latest available figures (1980) show births and deaths roughly in balance.

6. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ 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.

7. 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 ½ 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).

8. 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.

9. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 3,900 guarantees - about half to new businesses. Total lending under scheme is just under £132 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.

10 Government thinking again about loan Guarantee Scheme?

[Article in FT 24 May]

Scheme has only been in operation for a year. Premature to consider changes in it.

11. Progress with setting up Enterprise Zones?

Excellent progress being made. All eleven zones now in operation.

12. 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

EXTERNAL FINANCING LIMITS

1. 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.

INVESTMENT

2. 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.

3. 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.

4. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £ $\frac{3}{4}$ billion, latest estimates suggest that this may be nearer £1 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.

5. 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.

6. Private finance for NI investment?

We have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector. The NEDC will shortly be considering a report on the progress that has been made in devising schemes which meet these criteria.

7. 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

8. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the April figures again showed nationalised industry domestic prices increasing more rapidly than the RPI, by 14.1 per cent for NI against 9.4 per cent for all items RPI over the 12 months to mid-April. The restoration of this differential was expected, and reflects March increase in London Transport fares and ending of electricity industry's rebates to consumers. The removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than the RPI, largely because of increases in the energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

9. 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.

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million).

11. But what about net figure?

Delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is the gross figure which is the true measure of success of Government's privatisation programme.

12. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

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.

NORTH SEA AND UK ECONOMY

1. In view of falls in price of oil earlier this year, 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; reports that Phillips are postponing T-block complex and BP their Andrew field].

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

3. Government should do more to stimulate UK Continental Shelf oil production in 1990's

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

4. 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

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.

5. 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.

6. 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.

7. 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. Results of OECD Ministerial and IMF Interim Committee meetings?

At both meetings Finance Ministers reaffirmed that successful policies to reduce inflation were essential to create sustained recovery. They stressed urgent need for budgetary discipline, smaller fiscal deficits, monetary restraint, promotion of productive efficiency and reduction of rigidities in markets for labour and goods. Clearly both communiques accorded closely with HMG's strategy.

2. Governments 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.]

Not a question of U-turns. OECD governments meeting last week agreed reduction of unemployment 'cannot be achieved on a sustainable basis' unless inflation reduced. But not just industrial countries' view: 2 days later Interim Committee of International Monetary Fund - on which developing countries sit - agreed 'combating inflation is a necessary step for resumption of sustainable growth at a satisfactory pace reduction in inflation and inflationary expectations, in nominal and real interest rates and in existing rigidities is essential for steady expansion of output and reduction of unemployment'.

3. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10.6 to 6.8 per cent), Japan ($6\frac{1}{2}$ to 3), Italy (20 to 16) and UK ($12\frac{1}{2}$ to $10\frac{1}{2}$). Small reductions in Germany (to 5.2 per cent) and Canada (to $11\frac{1}{2}$), but increase in France (from $12\frac{1}{2}$ to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries.

4. 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.

5. UK policies out of line with other countries?

UK far from alone as made plain again in communiques from recent IMF and OECD meetings where Ministers reaffirmed commitment to reducing inflation and improving

productive efficiency. Most countries have already begun taking necessary medicine: US President agreed with Republicans in Congress on plan to reduce budget deficit further \$27 billion, following spending cuts last year. German budget deficit cut almost 30 per cent this year. President Mitterand has declared next year's budget deficit must not exceed 3 per cent of GDP. Italy, Netherlands, Belgium, Australia and Sweden have also announced measures to cut planned public spending. Irish Government also acting to reduce deficits. And most countries have set non-accommodating monetary targets.

6. 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.

7. Prospects for US economy?

[Commerce Department's index of leading indicators fell in March for 11th successive month. Industrial production is flat, and seasonally adjusted unemployment is 9 per cent. M1 significantly above target range after 4 months. But consumer price index fell in March, bringing year on year inflation to 6.8 per cent - rate over last 6 months 3 per cent at annual rate.]

Sixth consecutive month of falling US inflation rate very good news - stabilising influence for the world economy. Helped by realistic and flexible wage settlements in which unions have given job security priority over wage increases. Reasonable prospect US economy should pick up later this year.

8. US Budget compromise?

[President's compromise with Republicans to reduce budget deficit further £27 billion below latest estimate of cost of President's February proposals (\$132 billion) opposed by Democrat majority in House of Representatives. Independent budget plans abound.]

Important for many countries that agreement on US budget should be reached soon. President's latest proposal would keep Federal deficit around 3 per cent of GNP.

9. US interest rate developments

[Prime rates currently 16½ per cent - flat for several weeks. Treasury Secretary Regan's announcement last week that reduced Federal deficit would cause lower US interest rates by end of year had no immediate effect as short term rates had already eased half a point in anticipation of the compromise.]

Prime rate well below peak of 21½ per cent last summer. Settlement of Budget for fiscal 83 would improve prospects for lower interest rates, especially given recent rate of inflation in US.

10. Prospects for international interest rates?

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

11. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

Latest OECD forecast ('Economic Outlook') published in December; next not due to be published until July.

U FALKLANDS CRISIS EFFECTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates were falling before crisis; balance of payments remains healthy; output is recovering. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Effect of Falklands dispute on markets?

[After rising initially, interest rates have recovered to levels a little below those obtaining before crisis.]

Initial shock seems to have been absorbed without significant ill-effect, reflecting confidence in government handling. 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.

3. Effects of Falkland Islands dispute on sterling?

Only natural that markets unsettled. But markets are aware that underlying position of the UK is strong, with inflation falling, growth picking up and a healthy balance of payments surplus. Falklands dispute is small in relation to this overall macroeconomic picture; no question of it requiring any change in our basic economic strategy.

4. Will dispute with Argentine affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

5. Will freeze on Argentine assets affect standing of City?

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

6. Does freeze involve reintroducing exchange controls?

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

7. 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 crisis began.

8. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at \$34 billion - about half size of Mexico's or Brazil's.]

Sign of times that Argentine military aggression should create instability in global capital markets. All more important to negotiate settlement quickly and to discourage similar acts in future. [IF PRESSED on debt default possibility: Banks have taken fairly relaxed attitude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

9. Falkland Islands: Cost/Financing of operation?

[N. Statesman 21 May article on costs of maintaining British ^{presence} ~~presence~~ after repossession of Islands.]

No cash ceiling on cost of operation; needs of task force must and will come first. Obviously too early to assess cost - duration and nature of operation still unknown. When 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.]

10. 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.

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 most 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 1983. Most 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 fell slightly in Q1 1982 effected by bad weather and strikes nevertheless was over ½ per cent higher than the spring of 1981. Manufacturing output in Q4 1981 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. The average level of retail sales in the first 4 months of 1982 was 1 per cent higher than H2 1981. The volume of visible exports has tended to move erratically however the latest evidence suggests that the recent trend has been flat. The significant rise in the trend of visible imports volume which took place in mid-1981 has not continued in the early months of 1982. 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 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 rose by £109 million (at 1975 prices) in Q1 1982 the first increase since Q4 1979.

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) rose 1½ per cent in April however the year-on-year increase fell to 7½ per cent. Wholesale output prices rose ¾ per cent in April and are 8½ per cent above a year ago. Year on year RPI increase fell to 9.4 per cent in April. Year-on-year increase in average earnings was 11.0 per cent in March. 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.

BR £8.6 billion in 1981-82 financial year but distorted by the effects of the civil service dispute. CGBR (unadjusted) £0.8 billion in April 1982.

In banking April Sterling M3 rose $\frac{1}{2}$ per cent while M1 was virtually unchanged and PSL2 rose $1\frac{1}{2}$ per cent.

Visible trade has showed a surplus of £0.7 billion over the 6 months from September 1981. Current account surplus over same period of £2.7 billion. UK official reserves fell by \$0.8 billion to \$18.2 billion at end-April. At the close on 21 May the sterling exchange rate was \$1.7960 while the effective rate was 89.0.