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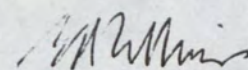
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 PS/Chancellor of the Duchy of Lancaster
 PS/Secretary of State for Employment
 PS/Paymaster General
 and officials in HMT, Revenue Departments
 and other Departments in Whitehall

TREASURY WEEKLY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 8 June, are
 sidelined.



B A COLLINS

RA

R I G ALLEN

14 June 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. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. Also agreed to intensify economic and monetary co-operation, to resist protectionary measures, not to use exchange rates to gain unfair competitive advantages and on a cautious approach to financial and trade relations with the Eastern bloc.

3. 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 particularly to help business, but also individuals, within responsible fiscal framework.

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

[Estimated PSBR outturn 1981-82 now about £8.9 billion (3½ per cent of GDP) cf £10½ billion at time of Budget March 1981 and still predicted in 1982 FSBR.]

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 relative to overseas rates in those months. Cannot assume 1981-82 shortfall will necessarily feed across to 1982-83; far less that Budget judgement needs revision.

5. 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. Latest estimates for outturn in 1981-82 suggest a ratio of about 3½ per cent, similar to ratio planned for 1982-83. But looking over a longer run of years trend is clearly downward. (See also Section H.)

6. Government's impact on inflation disappointing?

12-monthly RPI inflation rate in April $9\frac{1}{2}$ per cent - down from $10\frac{1}{2}$ per cent in March. Lowest figure for over three years. Then, inflation was accelerating. Now, trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. [But NB credence should not be given to DOI press release reporting Mr Jenkin as claiming inflation would fall to $7\frac{1}{2}$ per cent this year.]

7. Economic recovery in doubt?

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 and latest CBI assessment. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See also Section B.)

8. Trade figures disappointing?

No. Current answer remains in healthy surplus (£ $\frac{1}{2}$ billion) in 1982 Q1. Exports recovered in March and in last six months have held up better than many feared, given earlier loss in competitiveness. Imports up sharply since 1981 H1, reflecting in part higher activity and end of destocking. (See also Section L.)

9. Investment remains depressed?

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

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has retained 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.

10. Do FSBR forecasts still hold?

No reason to question broad shape of forecasts but in certain areas, eg inflation, progress is faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.]]

11. Outlook for unemployment?

[House of Lords Select Committee on Unemployment due to publish report on 16 June. June unemployment figures to be published 22 June.]

Not the practice to publish forecasts of unemployment. But current policies to tackle inflation provide only basis for sustained recovery and more jobs. (See also Section C)

12. Report on Budgetary Reform by the TCSC ("Armstrong" Report)

[Report to be published 17 June.]

Government cannot be expected to agree with all it says, but it seems carefully thought out and constructive, and the Government will want to consider its recommendations thoroughly. Reply will be made when the Government's study of the report's recommendations is complete. Will not attempt to predict a date at this stage.

13. Do you accept the TCSC's criticisms of the way decisions are taken and announced?

No, not wholly. Government drew attention in its evidence to the various practical and other constraints and also to the progress which had been made in the Armstrong direction under this Government (eg MTFs). Committee did not perhaps give full weight to what had been achieved. But cannot anticipate reply to the report. Will be thinking carefully about recommendations to publish Green Book /PEWP in January etc. Cannot anticipate reply.

14. Treasury model of economy 'rigged' to produce discouraging results from alternative policy packages?

See Section P.

15. Implications of latest fall in interest rates?

[Short-term rates down over $\frac{1}{2}$ percentage point on week ago; $3\frac{1}{2}$ per cent on autumn 1981 peak.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downward trend. Market perceived that conditions were right for a fall in rates and Bank acquiesced in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

16. SDP Policy Paper: Towards Full Employment

[Discussion Paper, first in series, published 7 June.]

Some proposals (eg emphasis on need to control growth in total money GDP) sensible, are not far removed from Government thinking (eg MTFs). But paper exaggerates extent to which expansion of special employment measures would provide genuine new jobs; advocates

'reflation' while largely ignoring possible damaging consequences (eg on confidence of business and markets); and advocates policies to control pay and prices very similar to those tried, and failed, in past.

17. Cost of Falklands?

Biffen
[Mr ~~Britten~~'s remarks 4 June.]

See Section U.

BULL POINTS

As at 14.6.82

- (i) Activity. Slight decline in GDP (output) in 1Q 1982 in part reflects effects of very severe weather and industrial disputes at turn of year. Most recent major independent forecasts, latest CBI assessment and cyclical indicators see prospect of further recovery in 1982-83.
- (ii) Investment. Private sector investment, particularly in plant and machinery, held up well relative to output investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 5 per cent higher than 1979. DoI investment intentions survey suggests 2 per cent rise in manufacturer's distributor's and services' investment in 1982.
- (iii) 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.]
- (iv) 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.
- (v) 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.
- (vi) Competitiveness. Cost competitiveness improved by at least 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.
- (vii) 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.
- (viii) Exports have held up better than many feared following earlier loss of competitiveness. Recent months figures suggest non-oil exports (excluding erratics) running at about same level as in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.
- (ix) 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 ¼'s since January 1981 and overtime working has increased.
- (x) 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.

(xi) 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.

(xii) 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.

(xiii) Inflation. 12 monthly RPI increase in single figures in April (9.4 per cent); more than halved since peak (21.9 per cent) in Spring 1980; lowest since January 1979. Trend now clearly downwards, not upwards as then. Manufacturers' input prices little changed since last August; up just 4½ per cent in year to May (lowest increase since November 1978). Manufacturers' output prices up just 8½ per cent in same period. CBI April survey shows lowest degree of unit cost pressure for 15 years.

(xiv) 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).

(xv) 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.

(xvi) Overseas debt repayments. Official external debt reduced from over \$22 billion in May 1979 to around \$13.7 billion at end-May 1982.

(xvii) 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?

[NB April industrial production figures to be published Wednesday 16 June]

[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. Investment intentions survey?

[DOI's investment intentions survey for May suggests rise in fixed investment in manufacturing distributive and service industries (MDS) of 2 per cent in 1982 and more substantial increase in 1983. Manufacturers investment (including leasing) expected to recover during course of 1982, volume for 1982 as a whole much the same as 1981 and to rise about 5 per cent in 1983.]

Survey, taken with rise in first quarter (see question 1 above) suggests trough in MDS investment passed in 1981, recovery gaining momentum during 1982 and 1983.

3. May CBI Trends Enquiry/Forecast Gloomy?

[In reviewing latest CBI situation report, FT (Monday 7 June) quotes CBI as claiming "Economy to remain in doldrums" Monthly Trends Enquiry suggests little change in order books in recent month and continuing approximate zero net balance of firms expected to raise output in next 4 months. The latest forecast suggests recovery to resume this year with 1 per cent growth in 1982, 2 per cent in 1983. Inflation forecast to fall to 9 per cent by end 1982, 7 $\frac{1}{2}$ per cent 1983. CBI expect continued improvement in company profits and financial position.]

Taken together monthly enquiry and forecast point to continuation of recovery during course of 1982 and 1983, lower inflation and improved profitability and financial position of companies. Forecast closely in line with Budget forecast and bulk of outside forecasts.

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 & Drew</u>	<u>CEPG</u>	<u>CBI</u>	<u>FSBR</u>
	(May)	(Apr)	(Apr)	(June)	(April)	(May)	(March)
Per cent change 1982 on 1981	+1	+1½	+1½	+1½	-½	+1	+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 C (unemployment), K (inflation) and L (balance of payments).]

C LABOUR MARKET

1. Recent unemployment figures?

[In May, unemployment (UK adult seasonally adjusted) rose by 22,000 to 2,872,000 (12 per cent). Total unemployment fell by 38,000 to 2,969,000 (12.4 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980	1981					
Q4	Q1	Q2	Q3	Q4	First 5 months 1982	
105	77	62	51	33	22]

May's rise (much the same as average monthly increase in Jan-April) confirms that unemployment has been rising more slowly this year than last.

2. Vacancy figures disappointing?

In May, vacancies (UK seasonally adjusted) fell slightly for third consecutive month to 107,000 compared with 113,000 in February. Vacancy flow data for April (latest month available) show inflow and outflow much improved - about 165,000 per month this year compared with about 145,000 per month in 2Q 1981.]

Despite recent falls vacancies still $\frac{1}{4}$ higher than at low point in Q2 1981 and turnover is also higher.

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. 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 6¾ 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?

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 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 ~~RE~~ 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 S

12. Merger of tax and social security planned?

See G

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. Government has complacent attitude to public expenditure?

No. The Chief Secretary told a Conservative Party Conference on Saturday 12 June that "the momentum of public spending programmes is frighteningly great. Unless all of you are able and willing to join us in pressing for new initiatives to control the escalation of public spending the prospect for greater tax incentives is bleak indeed".

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 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.

6. 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).

7. 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.

8. 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.

9. 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.

10. 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.

11. Revised cash limits 1982-82 announced 27 May

[In his Budget statement, after allowing NIS surcharge cut to help industry, the Chancellor announced that, in order to leave them where they would have been without the change, appropriate reductions would be made in relevant cash limits and votes of central government, in rate support grant to LAs and in EFLs of NIs and other public corporations. Revised EFLs for nationalised industries and for three other public corporations were given in answer to a written PQ on 7 April. (The revised figures included also certain other changes.) Further revisions to central government cash limits - published in written PQ 27 May.]

Revisions implement 'clawback' consequent on reductions in national insurance surcharge - a move intended to reduce business costs in the private sector. But as public sector employment also liable to the surcharge, appropriate reductions have been made to leave public bodies where they would have been without the change.

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

(See Sections F and K.)

13. 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.

LOCAL GOVERNMENT

14. 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-the-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 revised 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.

15. 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.

16. 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.

17. 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**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 have accepted the award which is now being implemented. 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) The report of the Megaw Inquiry into arrangements for deciding civil service pay in future may be made at the end of this month.

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 discussion with the unions.

4. Scott Report/Public sector pensions?

See K

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. 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.

4. 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?

[PSBR 1981/82 undershoot originally thought to be around £2 billion now seems to be less than this: latest PSBR figure £8.9bn]

A study of the reasons for the shortfall has revealed possible improvements which can be made to improve our forecasting technique. However the Civil Service dispute added considerably to the uncertainties at the time of the Budget and was the main influence on most of the errors.

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 A

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 3½ 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?

Detailed public expenditure outturn information for 1981-82 will not be available until early next month. Until then, implications for 1982-83 are uncertain. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBP 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 44½ per cent].

6. Implications of CGBR outturn in April and May for 1982-82?

[CGBR for April = £0.8 billion, for May (published 9 June) = £1.1 billion. April 1981 = £2.4 billion, May 1981 = £2.7 billion].

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. Too soon to make any amendment to forecast for the year.

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 £ $\frac{3}{4}$ 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. Dispute also damaged out ability to interpret and forecast the PSBR reasonably accurately (see question 1).

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 1981-82

[In banking May (third month of target period) £M3 rose by 1.2 per cent, bringing growth in the target period to 9.9 per cent at an annualised rate; M1 rose by 0.6 per cent (0.3 per cent at an annual rate this target period); PSL2 also rose by 0.6 per cent (9.8 per cent at an annual rate over the target period) - all figures seasonally adjusted].

Too early to judge outturn over target period as a whole, but recent figures encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing recent further falls in interest rates. Bank lending is still growing rapidly, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Too early to say whether growth is slowing, though Banking May figure lower than in preceding months. Part of recent rapid growth at least is in substitution for building society lending and other forms of consumer credit, but to the extent that it is additional it may add to inflationary pressures, so must continue to proceed cautiously on interest rates.

4. Recent falls in interest rates

Base rates cut from 13-12½ per cent wef 8/9 June. Continues decline seen since last October when base rates were 16 per cent. Market unease over Falklands disguised underlying trend. Recently rates eased creating the conditions for 8 June base rate cuts as victory comes in sight. The latest falls are consistent with continued progress against inflation.

5. Prospects for further falls

Of course want to see rates lower still, but we have only just seen a further welcome cut in base rates and we have to be cautious about the future. We shall not jeopardise counter-inflation policy, but in due course further progress with MTFs should lead to rates being lower still.

6. Will high and unstable US rates affect UK rates?

[US rates eased slightly over past month, but still high.]

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.)

7. 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.

8. 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.

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. How low by end 1982?

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.4 per cent in April, and should decline further over the year.

3. Chance of 7½ per cent inflation by end of year?

[Industry Secretary Speech to CBI 24 May.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cent is quite possible.

4. 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.

5. 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).

6. 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.

7. Inflation still not as low as competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

8. 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).]

9. 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).]

10. 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.

11. 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 (see also R8)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases 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 only possible if industries succeed in holding down current costs, particularly pay.

12. 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 direct impact of total package would add about $\frac{1}{4}$ per cent to retail prices index and $1\frac{1}{4}$ per cent to retail food price index in full year. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

13. 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.

14. 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.

15. 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.

16. 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.

17. 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.

18. Why only 4 per cent for MPs (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.

19. Top Salaries Review Board increases too large

[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.

20. 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.

21. 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]

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.

22. But real take-home pay has fallen over past year

Yes. But this follows growth of 17½ per cent in personal living standards in 3 years 1977 to 1980.

23. Index-linked pensions and the Scott Report?

The Government is considering whole question in light of 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.

24. Incomes Policy

[SDP Green Paper "Towards Full Employment" (published 8 June) includes proposal for permanent incomes policy]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

L BALANCE OF PAYMENTS

1. March trade figures?

[Figures published 7 June show current account in estimated £330 million surplus during March. Non-oil trade back in surplus for first time since October. Invisible surplus of £110 million lower than earlier projected in part reflects change in statistical treatment of EC Budget refunds (see 4 below). Current account surplus of about £½ billion in 1Q 1982 compares with £2½ billion in 1Q 1981 and about £1½ billion in 1Q 1981. For 1981 as a whole, estimated current account surplus (still partial data) now £7 billion cf Budget estimate of £8 billion.]

Figures still incomplete for 1981, and difficult to interpret. But current account remains in substantial surplus and exports holding up well.

2. Export trends gloomy?

[Figures remain extremely difficult to interpret, following last years Civil Service dispute and changed documentation procedures. Latest figures show apparent weakening in non-oil volumes in Jan-Feb reversed in Feb-March. Volume of non-oil exports (excluding erratics) in September 1981 - March 1982 much the same as 1980 average.]

Exports help up better than many feared following earlier fall in competitiveness. Present months figures suggest non-oil exports running at about same levels as in 1980.

3. Imports?

[Figures remain difficult to interpret (see 2 above). Non-oil import volumes between March 1981 and September 1981 higher than in low levels of 1Q 1981, since then broadly stable.]

Imports bounced back in 1981 as destocking came to an end. But increase in the volume of imports of finished manufactured goods since September 1981, suggesting that UK firms are being more successful in home market.

4. Disappointing trend in invisibles contrary to expectations

[Figures published 8 June show Q1 current account surplus of £0.6 billion, a visible trade surplus of £0.2 billion but a reduced surplus on invisibles of £0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that

comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected to UK companies. By increasing the links between UK and overseas companies, overseas investment helps UK exports and production producing more jobs. If the UK does not take profitable opportunities to invest overseas, others will.

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 close on 11 June were \$1.7726, DM 4.238 and an effective of 90.43. Reserves at end May stood at \$17.8 billion, compared with \$18.2 billion at end April.]

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. 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. Most recent reserves figures confirm that policy is unchanged.

3. 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.

4. Improve UK competitiveness by devaluing the exchange rate

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example although effective exchange rate depreciated by over a quarter between 1972 and 1976 competitiveness was unchanged, this remedy has been tried and it has failed.

5. 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 \$13 billion, compared with over \$22 billion when the Government took office.

6. French devalue to improve competitiveness

[At EMS realignment on 12 June the Deutschemark and Dutch guilder were revalued by 4.25 per cent; the French franc devalued by 5.75 per cent and the Italian lira devalued by 2.75 per cent]

EMS realignment conference on 12 June - at which the Chancellor assisted - adjusted exchange rates to allow for underlying market trends. The realignment - and accompanying measures taken - show that other European countries have the same priority as ourselves: to defeat inflation and so create the conditions for sustained economic growth.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Implementation of budget settlement

This is to be settled at Foreign Ministers' meeting on 21 June, and embodied in a Regulation thereafter. 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

3. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

4. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, 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 issues. Foreign Ministers are to consider the implications on 20 June.

5. UK objectives for longer-term negotiations?

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.

6. 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.

7. 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.

8. 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.

9. 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.

10. Policy for CAP reform

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

11. 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

12. 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.

13. 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	£bn	
			Year	H1	H2
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. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

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 (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 4,440 guarantees - about half to new businesses. Total lending under scheme is just over £149 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million available in year to May 1983. 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 under continuous review.

11. High failure rate under Loan Guarantee Scheme expensive for Government?

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

12. Enterprise zones: response from private sector?

All eleven zones now in operation. 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.

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.

S NORTH SEA AND UK ECONOMY

1. Impact of \$2.50/barrel rise in North Sea oil price on Government revenues?

[$\$2.50$ /barrel rise is a figure quoted in the press for negotiations involving BNOC and oil companies.]

Treasury estimate that a sustained $\$1$ /barrel rise in the North Sea oil price all other things being equal would directly raise Government North Sea revenues by about $\pounds 350$ million in a full financial year.

2. In view of falls in price of oil earlier this year, why did HMG not reduce tax burden on North Sea oil producers?

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.

3. 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.

4. 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.

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: $\pounds 6.4$ billion in 1981-82, $\pounds 6.2$ billion in 1982-83, $\pounds 6.1$ billion in 1983-84, and $\pounds 8.0$ billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March 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.

6. Is the Government underestimating North Sea revenues?

[Stockbrokers Scott Goff Hancock reported to be estimating Government revenues of £7.4 - £8.1bn in 1982-83, compared with FSBR estimate of £6.2bn]

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

7. 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.

8. 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.

9. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of the burden for less profitable, more marginal fields is appropriate to meet particular problems. The tax system introduced in the Budget, plus these changes, should enable the nation to get its fair share from the profits of this national asset, while leaving plenty of incentive to continue developing it.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Versailles Summit offers no prospect for reducing unemployment?

Today's unemployment is the bill we pay for having allowed inflation to continue so long in the past. But glad to note most forecasters expect resumed growth in activity in Summit countries later this year and next, which should help to halt the rise in unemployment.

2. Versailles summit: international monetary undertaking

Major countries explicitly accepted "joint responsibility to work for greater stability in world monetary system". Could be significant step towards greater stability if five countries whose currencies makeup SDR basket preserve value of their own individual currencies by reducing inflation at home. UK and France still some way to go in that respect.

3. Why didn't Summit countries together lead revival of Western economy?

Road to revival lies through combatting inflation. Remarkable unity at Versailles Summit at OECD Finance Ministers meeting and at Interim Committee of International Monetary Fund - on which smaller industrialised and developing countries sit - that reduction in inflation must precede sustained revival. IMF's Interim Committee agreed "combatting inflation is a necessary step for resumption of sustainable growth at a satisfactory pace". Most Summit partners have made good progress reducing inflation.

4. French and Italian devaluations?

[French franc devalued by 10 per cent and Italian lira devalued 7 per cent against Deutschemark on 12 June. Sixth and biggest revaluation in EMS's 3½ year history. Simultaneously French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Second EMS realignment this year was necessary because French and Italian inflation rates considerably above European partners. Strength and stability of Western economies as a whole will benefit if France and Italy can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy.

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (6½ to 3), Italy (20 to 15½) and UK (12 to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ 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. Realism in wage settlements is growing, US, Germany, Japan and UK all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

6. 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.

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?

[Commerce Department's index of leading indicators rose in April for first time in a year, but industrial production is falling and seasonally adjusted unemployment is 9.5 per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down for the 7th consecutive month to 6.6 per cent in April.]

Seventh 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.

9. US Budget?

[House of Representatives passed budget plan with projected deficit for FY83 of \$99 billion; Senate approved plan has deficit of \$116 billion. House and Senate meet this week in conference to work out compromise. The two chambers largely agree on total revenue to be raised next year but Senate wants smaller cut in social programme.]

Hope two Houses of Congress will soon reach agreement on budget for Fiscal year '83; must reach agreement on details as well as total expenditure and federal deficit.

10. US interest rate developments

[One major US bank cut its prime rate to 16 per cent - others so far stayed at 16½ per cent.]
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.

11. 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.

12. 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 higher than a year ago. 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?

[Markets have recovered some of the confidence lost in early days of dispute, and equity, gilt and money markets now stronger. Exchange rate holding up, and domestic interest rates now $\frac{3}{4}$ per cent lower than before crisis began]

Only natural that markets unsettled. But markets aware that underlying position of UK economy is strong. Shock seems to have been absorbed so far without significant ill-effect, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

3. Will dispute affect UK trade figures?

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

4. 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.

5. Effect of restrictions on Argentina?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of \$million have been suspended since crisis began.

6. 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.]

7. Falkland Islands: Cost/Financing of operation?

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 but economic strategy will not be relaxed, even if this involves higher taxes.]

8. 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.

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent during 1981 H2 then declined by $\frac{1}{4}$ per cent in 1982 Q1. Recent decline largely reflects impact of severe weather and strikes at turn of year. Despite weakening, underlying level of output remains above levels of last spring. Most independent assessments expect continued recovery during 1982 and 1983. Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Private housing starts up over one third in same period. Reflecting strong rise in private and public sectors, total housing starts in 4 months to April 1982 up one quarter on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Q1 figures suggest period of rapid destocking now over. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, but latter beginning to pick up in manufacturers, distributors and services (MDS) investment rose 5 per cent in certain areas in 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 7 months to March non-oil exports no lower than in 1980. Non oil imports have risen - up 11 per cent in same period - reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of $\text{£}\frac{1}{2}$ billion in 1Q 1982 following $\text{£}7$ billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between mid 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.6 million (less than fall in employment) and stood at 2.87 million (12 per cent) in May. Total unemployment (including school leavers) was 2.97 million (12.4 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 22,000 per month so far in 1982). Other labour market indicators improving; eg short-time working down by $\frac{1}{4}$ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by $\frac{1}{5}$ in 3 months to May on 2Q 1981, and with more rapid turnover.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent)

suggesting further moderation in current pay round. 12-monthly increase in RPI for first time in over 3 years well inside single figures; 9.4 per cent, in April. Recent progress suggests outturn to November this year could well be in Budget time forecast of 9 per cent. Manufacturers' input prices now no higher than last August; in 12 months to May they rose just 4½ per cent. Corresponding rise in manufacturers output prices 8½ per cent - lowest figure for over three years.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by at least 10 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (excluding North Sea) rose by over one quarter between 1H and 2H 1981, but real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 3 months of 1982-83 target period developing favourably in relation to 8-12 per cent target range.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate fell from 16 per cent in December to 12½ per cent early June. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. Provisional estimate suggests PSBR £8.9 billion in 1981-82 (3½ per cent of GDP, compared with 5¾ per cent in 1980-81) about £2 billion lower than estimated at Budget time. Precise reasons for 1981-82 shortfall not yet known; balance of implications, if any for 1982-83 PSBR unknown. FSBR forecast of £9½ billion (3½ per cent of GDP) remains best central estimate.

Exam Pd

PPS/CHANCELLOR

file no TEB/CA/01

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 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 24 May, are
 sidelined.

B A Collins
 B A COLLINS

RA

R I G ALLEN

8 June 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. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. We also agreed to intensify our economic and monetary co-operation, to resist protectionate measures, not to use our exchange rates to gain unfair competitive advantages and we agreed on a cautious approach to financial and trade relations with the Eastern bloc.

3. Versailles summit: international monetary undertaking

[Comminique stresses "joint responsibility to work for greater stability in world monetary system".] Major countries explicitly accept responsibility for international monetary system. This could be start of gradual move towards greater stability in the system.

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 particularly to help business but also individuals, within responsible fiscal framework.

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

[Estimated PSBR outturn 1981-82 now about £8½ billion cf £10½ billion at time of Budget March 1981 and still predicted in 1982 FSBR.]

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 relative to overseas rates in those months. Cannot assume 1981-82 short fall will necessarily feed across to 1982-83; far less that Budget judgement needs revision.

6. Government's impact on inflation disappointing?

12-monthly RPI inflation rate in April $9\frac{1}{2}$ per cent - down from $10\frac{1}{2}$ per cent in March. Lowest figure for over three years. Then, inflation was accelerating. Now, trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. [But NB credence should not be given to DOI press release reporting Mr Jenkin as claiming inflation would fall to $7\frac{1}{2}$ per cent this year.]

7. Economic recovery in doubt?

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 and latest CBI assessment. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See also Section B.)

8. Trade figures disappointing?

No. Current answer remains in healthy surplus (£ $\frac{1}{2}$ billion) in 1982 Q1. Exports recovered in March and in last six months have held up better than many feared, given earlier loss in competitiveness. Imports up sharply since 1981 H1, reflecting in part higher activity and end of destocking. (See also Section L.)

9. Investment remains depressed?

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

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has retained 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.

10. Do FSBR forecasts still hold?

No reason to question broad shape of forecasts but in certain areas, eg inflation, progress is faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.]]

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?

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?

[Report due to be published 17 June. Leak in FT, 7 June refers to the Committee proposing "major overhaul of the way public expenditure and tax decisions are taken, in direct rejection of his views of Sir Geoffrey Howe"]

Await TCSC report with interest. Proposals will 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 alternative policy packages?

See Section P.

15. Implications of latest fall in interest rates?

[Short-term rate down over $\frac{1}{2}$ percentage point on week ago; Midlands and National Westminster announce $\frac{1}{2}$ point cut in base rates 8 June.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downwards trend. Market perceived that conditions were right for a fall in rates and Bank acquiesced in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

BULL POINTS

As at 7.6.82

(i) Activity. Slight decline in GDP (output) in 1Q 1982 in part reflects effects of very severe weather and industrial disputes at turn of year. Most recent major independent forecasts, latest CBI assessment and cyclical indicators see prospect of further ^Crecovery in 1982-83.

(ii) Investment. Private sector investment, particularly in plant and machinery, held up well relative to output investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 5 per cent higher than 1979. DoI investment intentions survey suggests 2 per cent rise in manufacturer's distributor's and services' investment in 1982. Manufacturer's ^{investment} (including leasing) expected to recover during course of 1982, rise 5 per cent in 1983.

(iii) 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.]

(iv) 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.

(v) 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.

(vi) Competitiveness. Cost competitiveness improved by at least 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vii) 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.

(viii) Exports have held up better than many feared following earlier loss of competitiveness. Recent months figures suggest non-oil exports (excluding erratics) running at about same level as in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.

(ix) 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 ½'s since January 1981 and overtime working has increased.

(x) 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.

(xi) 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.

(xii) 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.

(xiii) 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.

(xiv) 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).

(xv) 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.

(xvi) Overseas debt repayments. Official external debt reduced from over \$22 billion in May 1979 to around \$1372 billion at end-May 1982.

(xvii) 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. Investment intentions survey?

[DOI's investment intentions survey for May suggests rise in fixed investment in manufacturing distributive and service industries (MDS) of 2 per cent in 1982 and more substantial increase in 1983. Manufacturers investment (including leasing) expected to recover during course of 1982, showing the volume for 1982 as a whole much the same as 1981 and to rise about 8 per cent in 1983.]

Survey encouraging taken with rise in first quarter (see labour). Suggests trough in MDS investment passed in 1981, recovery gaining momentum during 1982 and 1983.

3. May CBI Trends Enquiry/Forecast Gloomy?

[In reviewing latest CBI situation report, FT (Monday 7 June) quotes CBI as claiming "Economy to remain in doldrums" Monthly Trends Enquiry suggests little change in order books in recent month and continuing approximate zero net balance of firms expected to raise output in next 4 months. The latest forecast suggests recovery to resume this year both 1 per cent growth in 1982, 2 per cent in 1983. Inflation forecast to fall to 9 per cent by end 1982, 7 $\frac{1}{2}$ per cent 1983. CBI expect continued improvement in company profits and financial position.]

Taken together monthly enquiry and forecast point to continuation of recovery during course of 1982 and 1983, lower inflation and improved profitability and financial position of companies. Forecast closely in line with Budget forecast and bulk of outside forecasts.

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 & Drew</u>	<u>CEPG</u>	<u>CBI</u>	<u>FSBR</u>
	(May)	(Apr)	(Apr)	(June)	(April)	(May)	(March)
Per cent change 1982 on 1981	+1	+1½	+1½	+1½	-½	+1	+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 C3 (unemployment), K3 (inflation) and L6 (balance of payments).]

7. Latest National Institute (NIESR) forecast gloomy?

[End May review suggests current recovery "weakest for past 25 years" and suggests "some doubt as to whether period since last Spring should be considered genuine recovery at all". Forecast suggests output to rise 1 per cent pa in 1982 and 1983 unemployment (UK adult sa) to rise to 3 1/8 million by end 1983, inflation to fall to 8½ per cent in 1983, strong current account surplus (over £6 billion) in 1982 and 1983.]

Forecast for activity and inflation for 1982 broadly in line with FSBR and most major outside assessments (see 6 above). Expected that recovery be uneven particularly when affected by very severe weather and industrial disputes. Government never suggested initially recovery would be very rapid - NIESR forecast, broadly in line with FSBR and majority of outside forecast suggests continuing recovery and single figure inflation in 1982.

C LABOUR MARKET

1. Recent unemployment figures?

[In May, unemployment (UK adult seasonally adjusted) rose by 22,000 to 2,872,000 (12 per cent). Total unemployment fell by 38,000 to 2,969,000 (12.4 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980	1981				
Q4	Q1	Q2	Q3	Q4	First 5 months 1982
105	77	62	51	33	22]

May's rise (much the same as average monthly increase in Jan-April) confirms that unemployment has been rising more slowly this year than last.

2. Vacancy figures disappointing?

In May, vacancies (UK seasonally adjusted) fell slightly for third consecutive month to 107,000 compared with 113,000 in February. Vacancy flow data for April (latest month available) show inflow and outflow much improved - about 165,000 per month this year compared with about 145,000 per month in 2Q 1981.]

Despite recent falls vacancies still $\frac{1}{4}$ higher than at low point in Q2 1981 and is also higher. ^{turnover}
^

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. 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?

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 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. Revised cash limits 1982-82 announced 27 May

[In his Budget statement, after allowing NIS surcharge cut to help industry, the Chancellor announced that, in order to leave them where they would have been without the change, appropriate reductions would be made in relevant cash limits and votes of central government, in rate support grant to LAs and in EFLs of NIs and other public corporations. Revised EFLs for nationalised industries and for three other public corporations were given in answer to a written PQ on 7 April. (The revised figures included also certain other changes.) Further revisions to central government cash limits - published in written PQ 27 May.]

Revisions implement 'clawback' consequent on reductions in national insurance surcharge - a move intended to reduce business costs in the private sector. But as public sector employment also liable to the surcharge, appropriate reductions have been made to leave public bodies where they would have been without the change.

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

(See Sections F and K.)

12. 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.

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-the-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 revised 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 PAY1. 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. 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.

4. 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

[NB CGBR for May to be published 9 June.]

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 3½ 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 44½ 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 £½ billion of receipts delayed from March 1981 were collected, but some £1½ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £½ 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.

MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83

[In banking April (second month of target period) £M3 and PSL2 increased by $\frac{1}{2}$ per cent and $1\frac{1}{2}$ per cent respectively; M1 was flat (all seasonally adjusted). Target range is for annual rates of growth of 8-12 per cent. Provisional banking May figures to be published 8 June.]

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

[Speculation in markets that recent rapid growth has slowed. Provisional banking May money figures (and lending by London clearing banks) to be published 8 June.]

Too early to say whether growth slowing. Part at least of recent rapid growth is substitution for lending by building societies and other forms of consumer credit. To extent that it is additional, adds to inflationary pressures, so must proceed cautiously on 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 eased slightly over past month, but still high.]

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. 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.

7. 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.

8. 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.

9. 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.

10. Implications of latest fall in interest rates?

[Short-term rate down over $\frac{1}{2}$ percentage point on week ago; Midlands and National Westminster announce $\frac{1}{2}$ point cut in base rates 8 June.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downwards trend. Market perceived that conditions were right for a fall in rates and Bank acquiesced in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

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. Chance of 7½ per cent ^{inflation} by end of year?

[Industry Secretary Speech to CBI 24 May.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cent is quite possible.

5. 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.

6. Inflation still not as low of competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and (March figure) 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

7. 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).]

8. 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.

9. 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).]

10. 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 (see also R8)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases 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 only possible if industries succeed in holding down current costs, particularly pay.

11. 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

12. 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.

13. 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.

14. 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 for example 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 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]

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. Index-linked pensions and the Scott Report?

The Government is considering whole question in light of 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. March trade figures?

[Figures published 7 June show current account in estimated £330 million surplus during March. Non-oil trade back in surplus for first time since October. Invisible surplus of £110 million lower than earlier projected in part reflects change in statistical treatment of EC Budget refunds (see 4 below). Current account surplus of about £½ billion in 1Q 1982 compares with £2½ billion in 1Q 1981 and about £1½ billion in 1Q 1981. For 1981 as a whole, estimated current account surplus (still partial data) now £7 billion cf Budget estimate of £8 billion.]

Figures still incomplete for 1981, and difficult to interpret. But current account remains in substantial surplus and exports holding up well.

2. Export prices gloomy?

[Figures remain extremely difficult to interpret, following last years Civil Service dispute and changed documentation procedures. Latest figures show apparent weakening in non-oil volumes in Jan-Feb reversed in Feb-March. Volume of non-oil exports (excluding erratics) in September 1981 - March 1982 much the same as 1980 average.]

Exports help up better than many feared following earlier fall in competitiveness. Present months figures suggest non-oil exports running at about same levels as in 1980.

3. Imports?

[Figures remain difficult to interpret (see 2 above). Non-oil import volumes between September 1981 and March 1981 substantially higher than in low levels of 1Q 1981, and about 10 per cent higher than 1980 average.]

Sharp recovery in imports ie part reflects end to destocking and rise in activity.

4. Although trade figures are good, fall in invisibles surplus is bad news [£0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Why are interest and dividend receipts down when we have been investing so much abroad?

This is a very erratic series, subject to revision, and reflecting interest and profits on overseas investment in the UK as well as our investment abroad. Since 1979 we have achieved a substantial improvement in the UK's external balance sheet, and there is no doubt that in the longer run this will give us a valuable return in overseas earnings. [For the time being our overseas earnings may have been temporarily hit by the US recession; or may initially be taking the form of capital gains rather than income.]

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 4 June were \$1.7965, DM 4.236 and an effective of 90.69. 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. 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.

Most recent reserves figures confirm that policy is unchanged.

3. 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.

4. 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.

5. 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 \$13 billion, compared with over \$22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ~~euros~~ in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

3. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, 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 issues. Foreign Ministers are to consider the implications on 20 June.

4. UK objectives for longer-term negotiations?

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.

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. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

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 available in year just commencing. 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 under continuous review.

11. High failure rate under Loan Guarantee Scheme expensive for Government?

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

12. Enterprise zones: response from private sector?

All eleven zones now in operation. 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 £ $\frac{1}{4}$ 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.

S NORTH SEA AND UK ECONOMY

1. Impact of \$2.50/barrel rise in North Sea oil price on Government revenues?

[\$2.50/barrel rise is a figure quoted in the press for negotiations involving BNOG and oil companies.]

Treasury estimate that a sustained \$1/barrel rise in the North Sea oil price, all other things being equal, would directly raise Government North Sea revenues by about £350 million in a full financial year.

2. 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.

3. 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.

4. 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.

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 incorporate March 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.

6. 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.

7. 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.

8. 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. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. We also agreed to intensify our economic and monetary co-operation, to resist protectionist measures, not to use our exchange rates to gain unfair competitive advantages and we agreed on a cautious approach to financial and trade relations with the Eastern block.

2. Versailles summit: international monetary undertaking

[Comminique stresses "joint responsibility to work for greater stability in world monetary system".] Major countries explicitly accept responsibility for international monetary system. This could be slant of gradual move towards greater stability in the system.

3. 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.

4. 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 Ministers meeting earlier this month 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'.

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (6½ to 3), Italy (20 to 15½) and UK (12 to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ 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.

6. 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.

7. 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. 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.

8. 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.

9. Prospects for US economy?

[Commerce Department's index of leading indicators rose in April for first time in a year, but industrial production is falling and seasonally adjusted unemployment is 9.4 per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down for the 7th consecutive month to 6.6 per cent in April.]

Seventh 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.

10. US Budget compromise?

[Senate agreed a fiscal plan with a deficit of nearly \$116 billion; House of Representatives is considering 3 main plans this week; eventual differences between House and Senate plans will have to be ironed out in joint House-Senate Committee.]

Important for many countries that agreement on US budget should be reached soon. Senate's plan would entail Federal deficit of about 3½ per cent of GNP.

11. US interest rate developments

[One major US bank cut its prime rate to 16 per cent - others so far stayed at 16½ per cent.]

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.

12. 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.

13. 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 higher than a year ago. 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. Exchange rates also holding up well.]

Shock seems to have been absorbed so far without significant ill-effect, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

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. Effect of restrictions on Argentina?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of \$million have been suspended since crisis began.

7. 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.]

8. Falkland Islands: Cost/Financing of operation?

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.]

9. 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.

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession). After rising 1 per cent in 1982 Q1, GDP declined by approaching $\frac{1}{2}$ per cent in 1982 Q1, but remains above levels of last spring. Recent decline largely reflects weakening in industrial production which, though showing some recovery in February and March from weather and strike affected levels at turn of year, nearly $\frac{1}{2}$ per cent lower in 1Q 1982 than in 4Q 1981. Despite weakening, underlying level of manufacturing production remains some 2 per cent up on 2Q. New engineering and construction orders in 1981 up 15 and 11 per cent in volume respectively on 2H 1980. Private housing starts up over one third in same period.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Q1 figures suggest period of rapid destocking now over. Consumers' expenditure, Government consumption and fixed investment broadly flat in 1981. But latter beginning to pick up in certain areas in 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in manufacturers', distributors' and service industries' fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 7 months to February non-oil exports no lower (up $\frac{1}{2}$ per cent) than in 1980. Non oil imports have risen - up 11 per cent in same period - reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of some £1 billion in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between mid 1979 and 4Q 1981 (with about two-thirds concentrated in manufacturing), though rate of decline has slowed down. Unemployment risen by less than fall in employment. UK adult unemployment stood at 2.87 million (12 per cent) in May. Total unemployment (including school leavers) was 2.97 million (12.4 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 22,000 per month so far in 1982). Other labour market indicators; eg short-time working (down by $\frac{1}{3}$ during 1981) overtime (improved by over 10 per cent during 1981) and vacancies - despite slight weakening since February - up by 1/5 in 3 months to May on 2Q 1981 and with more rapid turnover.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) - suggesting a further moderation in current pay round. 12-monthly increase in RPI for first time in over 3 years well inside single figures, 9.4 per cent, in April. Recent progress

suggests outturn to November this year could well be in Budget time forecast of 9 per cent. Manufacturers' input prices no higher in April than last August. Manufacturers' output prices rose $8\frac{1}{2}$ per cent in year to April - lowest figure for over three years.

(v) Productivity and Competitiveness (manufacturing). Output per man rose 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak in 1H 1979. Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by at least 10 per cent during 1981.

(vi) Company finances. Gross trading profits of ICCs (excluding North Sea) rose by over one quarter between 1H and 2H 1981, but real pre tax rate of return just $2\frac{1}{2}$ per cent in 1981. Company borrowing fell and liquidity improved, but latest 4Q figures suggest some deterioration as destocking slowed and effects of civil service dispute (which delayed companies tax payments) unwind.

(vii) Monetary aggregates. $\pounds M3$ grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly, reflecting lower than expected government borrowing in 1981-82 and (temporary) effects of recovery from civil service dispute.

(viii) Interest rate/exchange rates. 3 month inter bank rate fell from 16 per cent last October to $13\frac{1}{2}$ per cent in mid March. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August. While Falklands Islands' dispute continues to unsettle markets exchange rates and interest rates little changed overall since dispute began.

(ix) Government borrowing. Provisional estimate suggests PSBR $\pounds 8.6$ billion in 1981-82 ($3\frac{1}{2}$ per cent of GDP, compared with $5\frac{3}{4}$ per cent in 1980-81) about $\pounds 2$ billion lower than estimated at Budget time. Largely reflects lower payments and higher underlying level of receipts than expected by central government, and lower borrowing by local authorities. Precise reasons for 1981-82 shortfall not yet known; balance of implications, if any for 1982-83 PSBR unknown. FSBR forecast of $\pounds 9\frac{1}{2}$ billion ($3\frac{1}{2}$ per cent of GDP) remains best central estimate.