

PPS/CHANCELLOR

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 PS/Secretary of State for Employment  
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 and officials in HMT, Revenue Departments  
 and other Departments in Whitehall

**TREASURY BRIEF**

I attach the latest version of this Brief. Changes from the previous Brief, of 23 August, are sidelined. During the Parliamentary Recess, this Brief is being circulated approximately once a month instead of once a week. The next will be dated 18 October, the day the House of Commons resumes after the Recess.

*M M Deyes*

M M DEYES

*27*

R I G ALLEN

21 September 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. Fiscal boost desirable?

If there were some quick and easy solutions we would have adopted them. What is needed now is to sustain steady economic policies designed to reduce interest rates and inflation, and to create climate in which industry can invest and sell its products. That does not mean, of course, that possible fiscal measures cannot be debated on their merits. But it does mean keeping in mind also their total effect on borrowing and interest rates, and on the economy generally.

### 3. 'Pact' with CBI?

[Press reports of Chancellor's bridge-building overtures.]

No question of any formal pact. But there is now a closer understanding between Government and CBI. Always has been a good deal of common ground. Industry's confidence remains unsettled by the high interest rates experienced towards the end of last year, and the limited extent of the recovery that has taken place. This makes it all the more important that encouraging pointers should not be ignored. Keep balance between trying to talk ourselves into economic revival - which would be naive - and undermining prospects of recovery by wilfully ignoring all signs of progress.

### 4. TUC attitude to NEDC

See P1.

### 5. Economy still in recession?

Natural for people to be concerned about present levels of industrial activity and employment. Output likely to be somewhat lower than forecast at time of Budget - partly because world markets are less buoyant than initially forecast. Recent figures (industrial production, GDP, fixed investment, cyclical indicators) disappointing. But clear that turning point was reached in first half of last year, and that, despite recent flatness, output is now higher - and recovery is projected to continue. Of course recovery so

far has been slow and patchy, with some industries remaining in great difficulty. It will probably continue to be so. Most encouraging pointers for future are progress against inflation (12-monthly RPI increase down to 8.0 per cent in August) and lower interest rates (down 5½ points since autumn 1981).

6. Chancellor's forecast of 6½ per cent inflation by end-year?

See K1.

7. Latest CBI assessments

See B3.

8. CSO's leading cyclical indicators

See B5.

9. Government policies have caused recession by deflating demand?

No. Output had fallen more strongly than demand during the current recession. At same time import penetration has continued on rising trend. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

10. What factors caused recent flattening out in recovery?

Recovery is slow and fragile. Number of factors - last summer/autumn's temporary rise in interest rates and pause in progress on reducing inflation; slower, and later than expected, world recovery - all probably weakened confidence and activity. These factors now working the other way, and will contribute to future recovery.

11. Tighter than expected fiscal policy to blame?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion. PSBR 1982-83 June quarter, seasonally adjusted, £1.6 billion. IMF Annual Report stresses size of deficit reduction in UK in last year.]

Fiscal policy stance 1982-83, so far as can be judged at this stage, consistent with Budget judgement. Monetary aggregates also on target. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen five <sup>and a half</sup> / percentage points since last autumn and this can only improve prospects for recovery. (See also Section H).

12. Falklands costs and the economy?

See E22-25.

13. Is there an impending world financial crisis?

Problem debtors (both corporate and sovereign) represent serious strain upon world financial system. System is able to cope, however, and is fundamentally sound. Furthermore, public authorities cannot be expected to protect debtors from necessity of economic adjustment. Nor can public authorities act as substitutes for application of prudent commercial lending criteria by the commercial banks.

14. IMF Meeting? US developments?

See Section T.

15. Recent interest rate/monetary developments?

During early part of 1982, UK interest rates fell despite high and volatile US rates. Steady reduction in UK rates made possible by satisfactory developments in main monetary indicators - monetary aggregates, exchange rate, and progress on inflation. (For further material on monetary developments, including bank lending, see section J.)

16. Record unemployment levels? Under-recording?

See Section C.

17. Report on Budgetary Reform by the TCSC ('Armstrong' Report)

[Government's reply published 5 August. Will involve some changes in Budgetary procedure in current year. But these will not go all the way towards implementing Committee's recommendations.]

Government intend to take full account of Committee's proposals in continuing to build on significant progress already made towards greater integration of economic decision-making (eg MTFs) and involvement in it of Parliament and public. In particular, Government will advance these developments by publishing around late November/early December an Autumn Statement which will allow fuller and better-informed discussion of monetary and fiscal prospects than in past. Structure and contents of Autumn Statement will build on what is already published and can be expected to evolve over time.

- (i) Activity. Recovery has begun: industrial and manufacturing output above levels spring 1981. [But NB, underlying level of output broadly flat since last Autumn.] Most recent major independent forecasts, see prospect of continuing, but gradual recovery later this year and next.
- (ii) Interest rates. Short-term rates have fallen  $5\frac{1}{2}$  points since last autumn (now about  $10\frac{1}{2}$  per cent). Lowest level for almost four years. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to 8-12 per cent target, Government borrowing under control, exchange rate firm.
- (iii) Inflation. 12-monthly increase in RPI now well inside single figures - 8.0 per cent in August - compared with spring 1980 peak (21.9 per cent). Inflation in August lowest since October 1978; trend now downwards not upwards as then. RPI index unchanged in August - third time no change in index in 1982. Prospect of inflation significantly below budget projection of  $7\frac{1}{2}$  per cent by end of 1982. Manufacturers' subject prices up  $7\frac{1}{4}$  per cent in year to August.
- (v) Costs.
- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
  - Manufacturers' unit wage and salary costs up only  $5\frac{1}{2}$  per cent up in year to 2Q 1982, below average of major competitors.
  - Manufacturers' input prices up just 3 per cent in year to August.
  - CBI July survey shows lowest degree of unit cost pressures for 15 years.
- (v) Manufacturing productivity. Output per head has risen about 12 per cent since end 1980. Output per head and output per hour now about 6 and 8 per cent higher than previous peak in 1H 1979.
- (vi) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains  $\frac{1}{3}$  worse than in 1975.
- (vii) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation, excluding North Sea) risen 40 per cent since 1Q 1981. Recovery in profits from very low base: ICC's pre tax real rate of return just  $2\frac{1}{2}$  per cent in 1981.

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(viii) Housing starts (total) - up over a quarter in first seven months of 1982 compared with average for 1981 as a whole.

(ix) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. In 11 months to July 1982 non-oil exports (excluding erratics) slightly higher than in 1980, despite earlier substantial loss of competitiveness.

(x) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83. Further measures announced end-July - new community work programme to start October, job splitting subsidy schemes from January 1983.

(xi) 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. Investment intentions survey of 231 German owned companies in the UK shows great majority intend to expand here in the near future.

(xii) Overseas debt repayments. Official external debt reduced from over \$22 billion in May 1979 to around \$12½ billion at end-August 1982.

Economic Briefing Division, HM Treasury, 01-233 5514/5503

## B ECONOMIC ACTIVITY AND PROSPECTS

### 1. Recent output figures

[Latest GDP figures (all three measures) suggest any growth in economic activity in H1 1982 over H2 1981 was slight, but about 1 per cent higher than in Q2 1981. Industrial production in three months to July unchanged compared with previous three months (a  $\frac{1}{2}$  per cent fall in manufacturing production being offset by a 4 per cent rise in oil and gas extraction). Trend in manufacturing activity at best flat and may be deteriorating.]

Total output, particularly manufacturing, in 1982 likely to be somewhat lower than forecast at Budget time, particularly because world markets are less buoyant than previously expected. However, rapid progress on inflation and interest rates plus higher productivity. Prospect remains one of continuing modest growth this year and next. View shared by most outside forecasters.

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

See Bull Points (following Section A).

### 3. Latest CBI assessments?

[CBI Monthly Trends Enquiry shows little overall change in total order books since November, but a deterioration of export order books since March of this year. Net balance of firms expecting to increase output in next four months has fallen (to minus 8) and net balance of firms reporting excess stocks has risen. Also further decline in net balance of firms expecting to increase prices in next four months. Latest forecast suggests only marginal rises in GDP (output) in Q3 and Q4 leaving GDP on 1982  $\frac{1}{2}$  per cent up on 1981].

CBI August Monthly Trends Enquiry and latest forecasts is further confirmation of temporary hesitation in activity since last autumn. Government always maintained recovery would initially be modest, slow and patchy. It will continue to be so particularly given more depressed world outlook. As with most outside forecasters the CBI expect gradual recovery over next 18 months and future financial developments to be favourable.

### 4. Fall in investment and reduction in stocks?

[Capital expenditure by the manufacturing, distributive and service industries in Q2 1982 4 per cent lower than level in previous quarter. Investment in manufacturing in H1 1982 was 3 per cent lower than in Q4 1981. Stocks fell by £30 million ('75 prices) in Q2; but in the first half of 1982 stocks increased by £100 million compared with destocking of £520 million in second half of 1981.]

Figures another manifestation of hesitation in economic activity. Despite this, investment in private sector, especially in plant and machinery, has held up well relative to output over last two years. [IF PRESSED: latest DOI investment intentions survey shows slight fall in manufacturing investment between 1981 and 1982; Q2 figure not inconsistent with this.]



5. CSO's index of leading cyclical indicators?

Longer leading index rose in August reflecting further falls in interest rates and an increase in share prices. Shorter leading index also fell between April and July. Implications of recent values of these leading indices for future movements in economic activity will not become clear until some more later data are available. The co-incident index has continued to increase from its low point in April 1981, with upward effects from most components.

6. FSBR forecast now looks too optimistic?

[Several independent forecasts have revised down their forecasts of growth in 1982 marginally (from around  $1\frac{1}{2}$  per cent to about  $1-1\frac{1}{4}$  per cent), largely reflecting the recent disappointing output figures. Despite this most groups have not altered their assessment of the strength of the recovery during the course of 1982 and in 1983, and most are more optimistic about financial developments, inflation and interest rates.]

Output growth for 1982 is likely to be less than expected at Budget time, in face of less buoyant world activity, but we have been doing rather better than expected on inflation. Clearly there are uncertainties and dangers, not least of which will be the international environment - though there are some recent indications that worst of recession is over in US. At present there is no reason to doubt the broad shape of gradual recovery into 1983 as forecast at Budget time. Certainly the majority of outside forecasters do not doubt it.

7. Latest Treasury forecasts?

Next publication of Treasury forecasts will be in Autumn Statement.

8. Outside forecasts

[GDP profile in recent major assessments:

	<u>NIESR</u>	<u>LBS</u>	<u>St James</u>	<u>Phillips &amp; Drew</u>	<u>CEPG</u>	<u>CBI</u>	<u>OECD</u>	<u>FSBR</u>
	(May)	(June)	(Aug)	(September)	(April)	(August)	(July)	(March)
Per cent change 1982 on 1981	+1	+1	$+1\frac{1}{4}$	$+\frac{3}{4}$	$-\frac{1}{2}$	$+\frac{1}{2}$	$+1\frac{1}{4}$	$+1\frac{1}{2}$

Nearly all see prospect of continued recovery (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and lower inflation. [See also ~~04~~ (unemployment)].

## C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

[UK seasonally adjusted unemployment excluding school leavers was 3,087,000 (12.7 per cent) in September. Total UK registered unemployed rose by 59,000 to 3,343,000 (14.0 per cent). Underlying increase in Q3 was 42,000 per month compared with 30,000 a month in Q2. Trend is deteriorating but no sharp rises now likely until January. UK seasonally adjusted vacancies decreased by 7,000 to 107,000 in September. Number unemployed for over 1 year was 1.071 million in July. Number unemployed for over 1 year was 1.071 million in July. Recent unemployment/vacancy figures shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2	Q3
Unemployment (UK adult sa) increase	+105	+77	+62	+51	+33*	+21*	+30*	+42*
Vacancies level	99	98	89	96	104	112	107	110.9

\*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (overtime, short-time, hours worked in manufacturing) also suggest some flattening out in improvement observed last year.]

Figures are tragic but problems took a long time to build up will also take a long time to check or reverse. Recent figures reflect the hesitation in activity since autumn. Only long term cure for unemployment is through sustainable recovery. However Government is doing a great deal to meet special difficulties and improve training. (see 7 below).

[IF PRESSED Apparent general weakening of labour market indicators can be interpreted as consistent with hesitation in recovery since last autumn. Cannot draw implications from July figures about future levels of unemployment.]

2. Unemployment higher than in other countries?

[On standardised definitions in Q1 1982 UK unemployment was 12.4 per cent compared with 7.4 per cent OECD rate; a UK doubling compared with an OECD rise of almost one half 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.

3. True unemployment figures really much higher?

[Sunday Times 19 September suggests 700,000 'hidden' jobless.]

No one seeks to deny there are unregistered unemployed but reliable estimates of their numbers are difficult to obtain. Available estimates vary quite widely. Figures of registered unemployed are based on accurate counts, have been accepted by successive administrations and provide reasonable estimates of trend.

4. Unemployment expected to continue rising rapidly?

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Though there has been some worsening in the underlying trend in unemployment this year, rise for year as a whole has only been some 40 per cent of rate over same period last year. Employment situation will benefit from some further recovery in activity this year and next (see B6). [IF PRESSED: Government has not sought to deny 3 1/3 million a likely figure this summer.]

5. What is Government's own forecast of unemployment?

Government does not publish such a forecast. However it was assumed for expenditure planning purposes in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (August) figure is 2.9 million - same as PEWP figure.

6. Employment continuing to fall?

[Total employment declined 2.2 million (9½ per cent) between mid 1979 and Q1 1982.]

Decline in Q1 1982 about one-third that in H1 1981. Best help for permanent jobs is sustainable recovery.

7. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

8. What is Government doing to provide more jobs?

Government pursuing balanced 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 1982-84; the new community programme which is designed to provide up to 130,000 places for the long term unemployed; and the new Job Splitting Subsidy which will be open on 1 January next year to encourage the extension of part time work and provide additional opportunities for productive jobs for unemployed people.

## 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 40½ per cent in 1981-82 and 39½ per cent in 1982-83. Corresponding figures excluding NICs are: 1978-79 28½ per cent, 1979-80 30 per cent, 1980-81 31½ per cent, 1981-82 34 per cent, 1982-83 33 per cent.]

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/real weekly net income fallen since 1979?

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But aggregate real personal income after direct taxes still higher than under last Government [although not true of all sections of population]. 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 has fallen in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

### 5. Personal tax burden increased by last Budget - when NICs taken into account?

The real increase in personal allowances and tax thresholds reduced income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers benefited from income tax changes and were 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 compensated 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 rose for most people, but fell for the lowest paid, ie below about ½ average earnings (married) and below about 1/3 average earnings (single).]

6. No improvement in incentives?

There will be 1.2 million fewer taxpayers in 1982-83 than if allowances had remained at 1981-82 levels, and  $\frac{1}{2}$  million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

7. Further cut in NIS?

[Called for by CBI].

Reduction that came into operation on 2 August (equivalent one percentage point cut for whole of 1982-83) will benefit private sector by £640 million in 1982-83 - on top of decisions to shield employers from increases in National Insurance contribution rates over last 2 years. Acknowledge desirability of further reductions. But expensive. Right time to consider this is autumn.

8. 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.

9. How has Government used fiscal incentives to encourage wider share-ownership?

Total of over 460 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979. Reflects liberalisation and extension of arrangements to promote profit-sharing and share-option schemes contained in 1980 Finance Act. Further fiscal encouragement on way from 1982 Finance Bill.

10. PAC report proposes new measures to curb 'black economy'

Government has read report with interest and will respond in due course in the usual way.

## 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 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). 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. Longer-term outlook for public expenditure?

[Economist 18-24 September reports radical CPRS proposals to cut public spending in the longer term were tabled but not discussed at special Cabinet on longer term 9 September, and predicts they will re-surface.]

There is a problem in that public expenditure has an inherent tendency to creep ever upward - though this Government has been more successful than most in putting the brakes on. Government is looking seriously at various options. Not necessarily question of 'decimating' services; rather of finding best ways of financing better quality with wider choice. No specific decisions have been taken as a result.

### 4. Increase spending in recession?

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

5. Spending Ministers seeking extra public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

6. Not enough 'productive' public investment/needs being jeopardised?

Government is not cutting 'productive' investment. Partly question of definition - within figures for capital expenditure totals, council house sales count as a negative item and defence procurement counts as current expenditure. Furthermore, nationalised industries are financing an increasing proportion of investment out of own resources. Also since mid-1970's needs have been declined; future standards and public amenities will not be jeopardised.

7. More capital projects in public sector to help private industry?

Government prepared to give priority to worthwhile capital projects within overall spending totals. However, no question of an artificial and inflationary stimulus to demand a new projects must be considered on their merits. Nationalised industries investment in 1982-83 planned to be about a quarter higher than in previous year. Real answer: to provide private sector with prospect of higher rates of return on investment by continuing policies to lower interest rates and increase incentives.

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. 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. Why so much underspending on Central Government voted cash limits 1981-82?

[Provisional outturn figures published 29 July].

Though rather more in 1981-82 than in each of previous three years, this is natural consequence of treating them as limits and not as targets. Extent of underspending on individual cash limits varies and is governed by a range of factors - which can differ markedly from one cash limit to another. In general, moderation in rate of inflation, which departmental managers may not have fully anticipated, made it easier to remain within cash limits.

11. Why so much underspending by local authorities on capital expenditure?

Number of reasons. Authorities got off to slow start because of 'knock-on' effect of the housing moratorium at the end of 1980-81; severe weather; lower tender prices working through. But overwhelming reason was success in selling council houses and unused land.

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.

13. What allowance will Government make for pay increase in public services next year?

Government attaches great importance to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans for 1983-84. (See also K8.)

14. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report in due course.

#### LOCAL GOVERNMENT

15. Overspending in 1982-83

Local authorities planning to spend some £1½ billion above Government's plans in 1982-83. In response, Secretaries of State have announced intentions to penalise over-spending by reducing the amount of grant to be distributed to them. (For details, refer to statements in Parliament 27/28 July by Secretaries of State.)



16. Local government finance 1983-84?

Because local authorities are spending so much this year, Government recognise they will spend more in 1983-84. So current expenditure provisions have been increased to ensure that they remain realistic. (For details refer to statements by Secretaries of State in Parliament 27/28 July). Figures announced are subject to consultation with local authorities, but Government is determined that they should be held to levels consistent with objectives for public expenditure and macro-economy.

17. Rate increases in 1983-84?

Spending in line with Government plans would imply only very modest increases overall, and in some areas no need for any increase at all. Of course, in areas where rating authorities overspend, ratepayers will bear a greater burden.

18. Lower rates for industry?

See P6.

19. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

20. 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.

#### FALKLANDS EXPENDITURE

21. Falklands defence costs?

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £570 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be minor in comparison. Totals should represent only a very small proportion of total public expenditure.

22. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Up to £10 million is being made

available. Not yet clear whether these costs will require additions to existing FCO and ODA funds and how far additional sums will be needed.

23. Cost of paying compensation for war damage?

Too soon to say what total will be. Claims are being processed, and further claims may be received. About £250,000 has so far been paid out, but this is no guide to what the final total might be. Not yet clear whether the compensation scheme will require an addition to existing FCO programme.

24. How will the various costs be met?

Intention is to try to absorb 1982-83 costs within the Contingency Reserve - and to some extent within existing budgets. Remains to be seen how far feasible. How future years' expenditure is to be funded will depend on decisions in forthcoming Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

25. Cost of proposals in Lord Shackleton's report?

[Published 13 September.]

The Report will need careful study, both in the UK and in the Falklands, before decisions on all these proposals are reached. In advance of these decisions not possible to say what cost might be.

Background which can be drawn upon: Estimates of cost given in the Report are:

£31-36 million for new development aid;

£40 million for offshore fishing;

up to £12 million for additional housing/infrastructure.

Total estimate of £83-89 million (at 1982 prices) excludes aid for rehabilitation and compensation for war damage already being made available.]

**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 10 per cent to 659,300. 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 smallest Civil Service since end of Second World war.

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

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 accepted award which is being implemented. Increases (announced 12 May) for higher civil service (under-secretary and above) were larger; they were decided in light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also E13 and K8).

**3. Megaw Inquiry**

Report of Megaw Inquiry into arrangements for deciding civil service pay in future (Cmnd 8590) contained number of important recommendations which are now being considered. (See also E14.)

**4. Civil Service pay: industrials**

Agreement reached for increases of about 6 per cent in pay year from 1 July 1982. Cost to be met from within existing cash provision.

**5. Scott Report/Public sector pensions?**

See K 16.

## G SOCIAL SECURITY

### 1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review when the benefit was brought into tax. We did not, however, commit ourselves to restoration of the abatement. We have undertaken the promised review, and have decided that we cannot afford to restore the abatement.

### 2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

### 3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

### 4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

### 5. Increase National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

### 6. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analyses possible future (up to forty years) cost of contributory benefits and levels of contributions needed to pay for them. Most important factor is increasing expenditure on earnings-related pension. Conclusions depend on assumptions about growth in earnings, prices, unemployment etc over period, but on certain assumptions contributions could change from present relationship to earnings - 16.5 per cent

combined employees' and employers' contributions - to 15.4 per cent by 1985-86, but rise to 16.7 per cent by 2005-6 and 21.9 per cent by 2025-6.]

Government Actuary's conclusions not firm predictions but illustrations of possible future burden on certain assumptions. We shall be considering report carefully before reaching any conclusion. In meantime DHSS will be consulting widely with interested organisations and would welcome comments by end of this year.

7. Death grant - increase to realistic level?

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

Social Services Secretary grateful for comments received on consultative document on death grant published in spring and is considering them carefully. As document made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

## H FISCAL POLICY AND THE PSBR

### 1. Progress on Fiscal Policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation has fallen fast and is expected to fall further (see K1). Apart from brief period in 1977, long term interest rates lower than at any time during last Labour Government. Benefits seen in recovery of debenture market. [IF PRESSED: excellent success in reducing interest rates, but state of economy makes it important to secure further reductions.]

### 2. How does UK fiscal stance compare with other countries?

[IMF Annual Report noted that among major industrial countries by far the largest 'restrictive shift' over past two years, equivalent to more than 3½ per cent, was that of UK.]

Many countries reducing borrowing; UK budget deficit now well below average of OECD countries. US experience shows that failure to bring fiscal and monetary policy into line can put excessive pressure on interest rates.

### 3. How much was PSBR undershoot in 1981-82 and why?

[PSBR for last year turned out £1.8 billion lower than estimate of £10.6 billion given in 1982-83 FSBR.]

Information is still incomplete, but higher debt interest receipts, better receipts from Inland Revenue and lower 'supply' issues contributed to the undershoot. Some factors went the other way - deficit on National Insurance Fund for instance turned out higher than expected. The civil service dispute added considerably to uncertainties at time of Budget, and was main factor in most of the errors.

### 4. 1981-82 undershoot shows fiscal policy too tight?

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in short term interest rates (5½ percentage points) since last autumn. Recovery of debenture market shows how lower PSBR creates room for investment.

5. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

6. Isn't 1982-83 PSBR likely to undershoot too?

[Budget forecast for 1982-83 was £9.5 billion. PSBR for June quarter £2.8 billion (£1.6 billion seasonally adjusted) - broadly consistent with forecast for 1982-83 as a whole.]

Rash to jump to conclusions about this year's PSBR. PSBR turned out higher than expected in 1979-80 and 1980-81. Last year, many people expected this to be repeated in 1981-82. PSBR figures for April-June quarter consistent with Budget forecast.

[IF PRESSED: Some of reasons for undershoot last year may imply lower PSBR this year (eg higher tax receipts). But other factors (pressure on Contingency Reserves from Falkland spending, changes in estimated NI contributions) could go other way. Unwise therefore to conclude £9½ billion forecast for this year's PSBR particularly high. Risks in both directions.]

7. Implications of CGBR outturn in August for PSBR in 1982-83?

[CGBR for August £1.5 billion; for April-August inclusive £5.3 billion. In 1981-82 CGBR for April-August was £9.3 billion.]

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. CGBR outturn to end August broadly consistent with Budget forecast of £9.5 billion PSBR in 1982-83, so far as can be judged at this stage. [NB: CGBR for September to be published 11 October; PSBR for September quarter to be published 21 October.]

8. 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 i.e 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.

9. Unadjusted PSBR misleading guide to fiscal action?

Cyclically-adjusted PSBR may have some merit as indicator but poor guide to fiscal policy. It is actual Government expenditure and revenue that determines the level of interest rates to be financed and influences level of aggregate demand.

10. Inflation-adjusted or 'real' PSBR in surplus - isn't fiscal policy too tight?

['Real' PSBR subtracts from actual PSBR erosion by inflation of real value of Government debt. Calculations by Bank of England and others produce a surplus 'real' PSBR in most years since the 60's].

Policy of this Government is to fight inflation, not to accommodate it. If 'inflation-adjusted PSBR' is in surplus, this calls for cut in inflation, not expansion of actual PSBR.



## J MONETARY AND FINANCIAL POLICY

### 1. Monetary growth in 1982-83 on target

[The target aggregates M1, £M3 and PSL2 grew by 1.2, 1.4 and 1.1 per cent respectively in banking August. These changes bring rates of growth in the 1982-83 target period to 8½, 11½ and 8½ per cent per annum respectively, compared with target range of 8-12 per cent (all figures seasonally adjusted).]

Actual August increases in money supply higher than those of past few months, but rates of growth of all three target aggregates are within Government's target range. Together with behaviour of exchange rate and progress in reducing inflation, they indicate sound domestic monetary conditions.

### 2. Prospects for further reductions in interest rates?

[Last reduction in bank base rates made on 31 August to 10½ per cent. Have come down by two points since early July.]

Substantial interest rate reductions this year reflect sound monetary conditions. Government would like to see rates lower still, so long as further reductions do not seem likely to endanger progress on inflation.

### 3. Effect of US interest rates on ours?

[US rates fell substantially during July/August, but firmed a little mid-September.]

The falls in US rates were helpful and facilitated reductions in our own. But of course US rates are not sole determinant of UK's, and this spring progress was made in reducing ours at a time when US rates were rising. UK rates are determined in the light of domestic monetary conditions generally, including the behaviour of the exchange rate.

### 4. Monetary conditions too tight - stifling recovery?

No. Behaviour of exchange rate and money supply suggest financial conditions moderately restrictive, as intended. Interest rates reductions have cut companies' cost and should promote climate for investment.

### 5. Bank lending growing too fast?

[Lower growth rate in May/June not maintained in July/August. Increased by £1.3 billion in banking August (seasonally adjusted).]

Rapid rate of growth has been partly the result of structural changes, such as move by banks into home loans market, replacing lending by building societies. But to the extent that the increases are additional, they may add to inflationary pressures. An argument for caution with regard to interest rate falls. Too early to expect figures of actual disbursements by banks for house purchase to reflect the bank's declared intention to go easy on this side of

their business. Not expected that removal of HP controls in July will have led to a surge in other personal lending.

6. Prospects for reactivation of corporate bond market?

[Tax treatment of zero coupon and deep discount stocks and removal of embargo on company issues of this type of stock announced 24 June. BOC announced issue of £100 million conventional bond 10 September.]

Zeros broaden options available to companies, though not expected to transform capital market. Best hopes for resurgence of market provided by lower interest rates and inflation, for which we are on course.

7. Why has Bank of England been providing such large-scale money market assistance?

The rapid growth of bank lending has caused problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system it has been possible to contain the rapid growth in money which could otherwise have taken place. This in turn has created shortages of liquidity in the money markets. If the Bank had not intervened to relieve these, short-term interest rates would have been forced up to unnecessarily high levels. The measures announced in June [ie variable rate loans facility made available to local authorities etc from the National Loans Fund/Public Works Loans Board; companies allowed to issue zero coupon and deep discount stocks] should reduce rate of growth of bank lending, by encouraging LAs etc to borrow from the NLF instead and by broadening options available to companies issuing their own debt, and so reduce levels of assistance required.

## K PRICES AND EARNINGS

### PRICES

#### 1. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

Chancellor has recently predicted [in Washington 20 September] that inflation could be as low as 6½ per cent by end 1982.

#### 2. Inflation lower than 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 13.2 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (August 1982) 8.0 per cent and falling. We will be first Government for quarter of a century to achieve a lower average rate of inflation during its term of office than the previous Administration.

#### 3. Inflation still not as low as competitors?

[UK inflation in July 8.7 per cent compared with 6.5 per cent in US, 5.6 per cent in West Germany, and 1.7 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.

#### 4. Long term inflation objective?

Recent developments encouraging. But inflation rate still higher than some competitors e.g. Germany. Must not let up. Have always made it clear that price stability not unattainable.

#### 5. TPI now shows pay increases need to be 1 per cent higher than RPI to maintain living standards?

[Increase in TPI over 12 months to August 8.7 per cent, compared with RPI increase of 8.0 per cent].

The gap between the RPI and the TPI (now 0.7 percentage points) widened in July when benefits paid to the unemployed became taxable. Pay increases go to people in work, who will not pay any more tax as result of the change - except for the minority who have a spell of unemployment during the year.

6. Nationalised industry prices

[Increase over 12 months to August 13.6 per cent, compared with RPI increase of 8.0 per cent].

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. The differential between RPI and NI prices (including water charges and London Transport fares) is now 5 per cent compared with 14 per cent in January 1982. But sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also R1.).

PAY

7. Zero pay norm in next round?

This Government is not in the business of setting pay norms. Individual pay bargains need to take realistic account of the particular circumstances, and of the fact that the greater the restraint, the better prospect for jobs. No right to automatic pay increases every year.

8. Will there be a new pay factor for public expenditure?

[Press reports suggest 4 per cent to be prescribed for public service pay in next round.]

Not yet been decided whether plans for next financial year will be calculated on basis of an explicit 'pay factor'. However, Government finances large proportion of country's pay bill; will have to ensure its own actions are compatible with overall needs of economy.

9. What pay settlements does Government now want?

Low enough to be consistent with improved job prospects in the industry concerned. The lower the better. Certainly lower than in the past year.

10. What has been average over past year/pay round?

[CBI Databank suggests 7 per cent average for manufacturing in last (1981-82) pay round].

Average has been in single figures, and moving downwards, in each of past two years. We need a substantial further reduction, with really low settlements, and thus a better outlook for jobs, in the year ahead.

11. Government exhortations on pay imply aiming to cut living standards?

[Real earnings show some improvement over past two years; in July 1982 2 per cent higher than July 1981 and 3 per cent higher than July 1980.]

Lower pay settlements have not in fact cut real earnings in either of the past two years; prices have also come down. This fact casts doubt on the wilder claims about the effect of pay moderation on living standards.

12. 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.

13. NHS pay

Social Services Secretary announced 23 June that a further £90 million should be made available for increased pay offer in Health Service. This would allow increase in average pay for nurses of 7½ per cent, ambulance men and hospital pharmacists 6½ per cent, and other staff 6 per cent. Government believes this provides sound basis for settlement.

14. 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.

15. Average earnings index

[Year on year growth 10.9 per cent in June compared with 9.8 per cent in June. However, underlying (unpublished) increase slightly lower than in June at around 9¼ per cent.]

Encouraging that underlying rate of growth continues to fall. July index inflated because of back pay and delayed settlements paid in July 1981 (eg civil servants). Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

16. Index-linked pensions and 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. Trade Figures and Current Account

[July trade figures show trade account in broad balance though non-oil trade has shown increasing deficit; projected invisibles surplus of £260 million a month in Q2. Cumulative current account surplus of £1.6 billion in first half of year.]

Signs are that the current account continues in substantial surplus, albeit reduced from last year's levels.

### 2. Export Trends

Exports during 1982 have been very erratic. The underlying trend seems to have been fairly flat following some rise during 1981; export volumes now at around 1980 level. Manufacturing exports in Q2 were lower than expected around Budget time, due largely to lower than forecast growth in world trade.

### 3. Import Trends

Manufactured imports fell back in June and July from their high May levels. Hard to discern trend in imports. But underlying level of manufacturing imports has probably not altered since end-81 reflecting levelling off in manufacturing activity.

### 4. Figures for 1981

Only the 1981 July and August export figures now remain to be published. These should become available over the next two months.

### 5. Will dispute with Argentina affect UK trade figures?

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

### 6. Overseas investment takes jobs away from UK?

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

## M EXCHANGE RATE AND THE RESERVES

### 1. Policy towards the exchange rate/falling £?

[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. Rates at noon on 17 September were \$1.7084, DM 4.2727 and an effective of 91.44. Previous lows were \$1.6870 on 9 August, DM 4.098 on 21 May. Highs were \$1.97 on 30 November, DM 4.407 on 9 February. Reserves at end August stood at \$18.1 billion, compared with \$17.9 billion at end July.]

Government has no target for exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Sterling's effective exchange rate has continued to show the stable pattern of recent months.

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

Policy is unchanged. Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions unsettled. But, as 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 value of dollar?

All experience in recent years 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: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

### 4. Improve UK competitiveness by devaluing 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 the effective exchange rate depreciated by over a quarter between 1972 and 1976 without leading to any improvement in UK competitiveness.

### 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. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council was signed on 30 June and ratified by the European Parliament on 8 July. It will provide the basis for settling the 1982 budget dispute, and also contribute to avoiding such disputes in future.

#### 2. 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 ecus 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.

#### 3. 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.

#### 4. Implementation of budget settlement

Details still under discussion in Brussels. The 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.

#### 5. Luxembourg Compromise

We made clear in Foreign Affairs Council on 20 June that we wished to have clarity about the EC's decision-making procedures. Four other member states shared our wish to re-establish the principle of unanimity when vital national interests are invoked. This is an improvement on 1966, though it is still an agreement to disagree.

#### 6. Commission's ideas for changes to 'own resources' system

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.



7. Policy for CAP reform

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

8. 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

9. 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.

10. 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.

EXPORT CREDITS 'CONSENSUS'

11. Progress on Export Credit Consensus negotiations

In October 1981 participants of OECD-sponsored 'Consensus' reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. Further proposals were discussed at an EC Council of Ministers on 30 June. They included reclassification of some countries and increase in interest rates charged to 'rich' and 'intermediate' country borrowers. These proposals have now been agreed.

P **INDUSTRY**

1. NEDC - TUC attitude

[On 8 September, at TUC Conference, TUC debated whether it should withdraw from the NEDC. The motion was defeated.]

Glad TUC voted to remain in NEDC. Believe the Council is a most useful forum for exchanging views on economic and industrial matters. In addition, little Neddies - the EDCs and SWPs - do a first rate job in helping to improve industrial performance at sector level. It would have been most unfortunate if all this had been undermined by TUC withdrawal.

2. Prospects for industry-recovery?

See A5 and B1.

3. Companies' financial position?

	1979	1980	1981 Year	H1	H2	1982 Q1
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	+3.5
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3	-0.5]

Financial position of industrial and commercial companies (excluding North Sea) improved last year, relative to 1979 and 1980. Improvement in part reflected companies' efforts to cut costs, for example by de-stocking. Some apparent deterioration in second half 1981 financial position due to slowdown in de-stocking and unwinding of delays in tax payments because of the civil service dispute. Figures for H1 1982 suggest reduction in companies' borrowing requirements relative to H2 1981; but borrowing needs still high.

4. Profits rate of return still too low?

[Gross trading profits of industrial and commercial companies (ICCs) (net of stock appreciation) rose 40 per cent to Q1 1982. But increase was from very low base: ICC's real pre-tax rate of return just 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Government can help best by getting inflation down and setting sound basis for sustained recovery. Fundamental improvements in ICC's rates of return depend on better performance by companies. Some encouragement from recent productivity gains and trend towards moderate pay settlements.

5. High interest rates damaging for industry and investment?

Banks' base rates have fallen 5½ percentage points since last October, and 2 points over last

three months. Outside analysis suggests that a 1 per cent reduction in interest rates improves the net financial position of the company sector by about £150 million over a full year. Lower interest rates reflect Government's firm fiscal and monetary stance and will help industry and investment.

6. Lower rates for industry?

De-rating one of a number of possible ways of assisting industry and business, but in last Budget preference given to other forms of relief, notably reductions in NIS. De-rating would be expensive, though less so if applied to industry alone - even so, 10 per cent de-rating would cost about £140 million per annum. Legislation would be required.

7. 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.

8. Response to Loan Guarantee Scheme?

[Over 6,000 guarantees already issued - about half to new businesses. Total lending under scheme just over £200 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating. (Report on sample survey of borrowers placed in Library of House by Parliamentary Under Secretary of State for Industry (Mr MacGregor) on 12 July).]

Scheme operating successfully. Too early to assess overall cost. After first year, of 6000 guarantees issued, only 150 have so far been 'called'. Cost has been covered by the premium income received over the period. Scheme is kept under continuous review.

9. Enterprise zones

Chancellor announced Tuesday 27 July eleven new Enterprise Zones to be created: 7 in England; two in Scotland; one each in Wales and Northern Ireland. All first 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

### NATIONALISED INDUSTRY PAY AND PRICES

#### 1. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry prices, water charges and London Transport fares than all items RPI (13.6 per cent in August compared 8.0 per cent). This differential reflects March increase in LT fares. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in 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. The differential between RPI (all items) and NI prices (including water charges and London Transport fares) is now 5 per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

#### 2. What is Government doing to improve Nationalised industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance aims. A rolling programme of Monopolies and Mergers Commission investigations has been set up. The introduction of market forces provides greatest incentive to efficiency.

### INVESTMENT

#### 3. Nationalised industries' investment should be stepped up to/improve infrastructure/provide orders to private sector/as boost to economy

Government has not prevented the industries from carrying forward a large number of profitable investment programmes. It would be wasteful to provide funds for public sector projects with lower returns than those in the private sector. Unfortunately, the pre-tax rate of return on nationalised industries' capital (including subsidies) in 1980 (latest available figures) was minus one per cent, compared with 3 per cent for industrial and commercial companies.

#### 4. Finance more nationalised industry investment by cutting current spending?

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.

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?

In discussions in NEDC and elsewhere, 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. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) 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.

#### EXTERNAL FINANCING LIMITS

8. 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). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

#### PRIVATISATION

9. 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). True that delivery of

BNOOC 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 gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

10. 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) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not before next Election.

11. Will Government postpone Britoil sale in view of the weak oil market?

Government intends to sell majority of Britoil shares by end of 1982, if market conditions permit. Will take decision on whether to go ahead when the time comes.

12. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

13. 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. Is Government underestimating North Sea revenues?

[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 1984-84. Lower than last year's projections, principally because of downward revision to oil price expectations].

Projections of oil revenues very uncertain and crucially dependent on cost, price and production assumptions. Prospects for North Sea revenues have improved since FSBR published. Lower recent estimates of Scott, Goff and Hancock and the Midland Bank Review are based on higher expected future production and lower expected future capital expenditure.

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

[Shell/ESSO have shelved plans for Tern partly because of tax system; Phillips postponing T-block complex and BP their Andrew field; BP statement issued with their interim results criticised fiscal regime.].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study has shown that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new structure will provide more secure and stable tax regime.

### 3. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Act Section 34) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

### 4. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on Depletion Policy published 18 May: emphasised development of fields entering production in 1990s by increasing pace of licensing rounds and overhauling fiscal regime. Recommended reserve powers to impose production cuts. Joint memorandum from Energy Secretary and Chancellor replied on 29 July].

HMG agrees with general conclusions encouraging North Sea exploration and development, thereby maximising economic oil production over time; eg decision recently announced not to impose production cuts before 1985. Agree uncertainties in oil scene too great to justify deferring new field developments in foreseeable future. Cannot accept Committee's

criticism of North Sea fiscal regime - opposed to another fundamental review; industry does not want a structural upheaval.

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

[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 lower level of interest rates to benefit of industry and 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. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available.

7. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOG.

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 fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil 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 possession of oil to require a contraction in our industrial base.



## T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

### 1. Annual meeting of IMF/IBRD

[Annual meeting of IMF and IBRD held in Toronto 6-9 September.]

UK contributed valuably to useful discussions in Toronto. Meeting considered the grave current economic situation and strains upon the world's financial system. Discussion emphasised the need to continue the fight against inflation and also the basis soundness of the financial system. Progress also made towards 8th general review of quotas.

### 2. IMF gloomy about world economic prospects?

[IMF Annual Report generally gloomy about immediate prospects: 1982 shaping up as another year of weak expansion.]

IMF does not foresee strong recovery in 1982. However stresses the importance of continuing the fight against inflation, and not giving way to pressure for inflation. IMF also pointed to rigidities in wage-bargaining system in the UK as elsewhere, as important causes of unemployment.

### 3. Why don't major industrial countries together expand demand?

Both IMF and OECD have stressed need for continuing fight against inflation. As the OECD's Economic Outlook explains, Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...'

### 4. Anti-inflation policies are working

[Inflation down from a year ago in 6 or 7 major economies on latest available figures: US down (from 10.7 to 6.3 per cent), UK (11.5 to 8.0 per cent), Japan (4.3 to 1.7 per cent), Italy (19.2 to 17.2 per cent), Canada (13.0 to 10.8 per cent) France (13.4 to 11.9 per cent).]

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 and Japan 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.

5. French government 'seen the light' over reflationary policies?

[After prices and incomes freeze announced in June and F.Fr 10 billion economies in social security spending announced July, budget for 1983 was announced on 1 September. Some details have still to be announced but borrowing will again be kept below the 3 per cent of GDP ceiling. French Government also raised \$4 billion over 10 years on international capital markets to defend present parity of the franc.]

Strength and stability of Western economies will benefit if all countries [particularly 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.

6. Comparison of French Socialist Government 1981-82 with Labour Government in 1974-76?

Many similarities. After oil price shock both governments gave fight against inflation low priority and sought immediate economic growth. In both cases unemployment rose strongly - in UK's case it doubled - inflation and rates of increase in earnings rose, current accounts ran substantial deficits and currencies were depreciated. Important differences, though: French economy fundamentally more healthy, French labour force less unionised, France committed to EMS, but no prospective North Sea oil to help out current account.

7. US Budget?

[Congress agreed in August on package of tax increases totalling \$98.3 over next three years, and some spending cuts. Still discussing further spending cuts.]

Glad Congress has acted to reduce deficits. Even so, US deficit remains high. Hope that Congress will continue with firm resolve to reduce deficits.

8. US interest rate developments

Rates fell considerably through July and August - though have turned up recently. Prime rates have fallen 2½ percentage points since mid-July and now stand at 13½ per cent. Growing concern over the Fed's intentions towards buoyant monetary growth may block any further fall in interest rates in the short term.

9. Prospects for US economy?

[Q2 GNP show small rise in GDP after falls of more than 1 per cent in Q4 and Q1. Seasonally adjusted unemployment is 9.8 per cent. Consumer prices and manufacturing earnings both rising at 6-7 per cent. Tax cuts, effective 1 July, expected to boost consumer spending in Q3 and 4.]

Some indications that worst of US recession may be over. However recovery may be hesitant. Encouraging signs on the recent fall in interest rates and long term downward shift in nominal wage settlements [noted by Chairman Volcker in testimony to Congress].

Recent settlements in manufacturing have been around  $6\frac{1}{2}$  per cent. If combined with productivity improvements these could lead to lower inflation rate in US.

## 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 between 1981 Q2 and 1981 4Q then declined by  $\frac{1}{4}$  per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes. 1982 Q2 GDP rose slightly, returning to its level in Q4 1981. Output nearly 1 per cent above its low point in the Spring of last year.

Underlying level of output broadly flat in first half of 1982, index of industrial production unchanged in 3 months to July compared with previous 3 months implying an increase of 2% per cent on total output since the trough in the Spring of 1981. Oil and gas extraction increased by 4% per cent between 1Q and 2Q 1982 while manufacturing production fell  $\frac{1}{2}$  per cent. Most independent forecasts expect resumed and continued recovery.

Volume of new engineering and construction orders in 1981 up 14 and 12 per cent on 2H 1980. Whilst the level of engineering orders has shown no further improvement in the first five months of 1982 construction orders rose 2 per cent in 1H 1982 compared with their average 1981 level. Private housing starts up over one third between 2H 1980 and 1981 and total housing starts in first seven months of 1982 up over a quarter on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, up 4 per cent between 1981 Q4 and 1982 Q1 (though with some weakening in some areas in 2Q 1982); 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 a little difficult to interpret. Exports have held up better than many had feared. In 11 months to July non-oil exports (excluding erratics) fractionally above the level of 1980. Non oil imports (excluding erratics) have risen - up 12 per cent in same period - in part reflecting reduced rate of destocking and further rise in import penetration ratio. Current account estimated to be £2.0 billion in surplus in first seven months of 1982 following £6 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.2 million (10 per cent) between 2Q 1979 and 1Q 1982 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.8 million since 2Q 1979 (less than fall in employment) and stood at 3.04 million (12.7 per cent) in September. Total unemployment (including school leavers) was 3.34 million (14.0 per cent). Underlying rate of increase in unemployment was 105,000 per month in 4Q 1980, cf 31,000 per month in first nine months of 1982. Other labour market indicators improved during 1981; eg short-time

working down by  $\frac{1}{3}$  during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by  $\frac{1}{5}$  in 2Q 1982 on 2Q 1981, and with more rapid turnover. Little or no further improvement in other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay around 10 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 8.0 per cent in August; well inside single figures. Recent progress suggests outturn to end-1982 could well be less than  $7\frac{1}{2}$  per cent. Manufacturers' input prices up only 3 per cent in 12 months to August. Corresponding rise in manufacturers' output prices  $7\frac{1}{2}$  per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen about 12 per cent since end-1980. Output per man and output per man hour about 6 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, and up by only  $5\frac{1}{2}$  per cent in year to 2Q 1982. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about  $\frac{1}{3}$  worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just  $2\frac{1}{2}$  per cent in 1981. Despite rise in company borrowing and return to financial deficit in 9 months to 1Q 1982 (largely reflecting reduced rate of destocking, rise in fixed investment in 1Q 1982, 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 6 months of 1982-83 target period M1, £M3 and PSL2 grew by 8.4, 11.2 and 8.8 per cent at annualised rates respectively of target range of 8-12 per cent.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; 3 month inter-bank rate has fallen from 16 per cent in December to about  $10\frac{1}{2}$  per cent. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since August 1981.

(ix) Government borrowing. PSEB £8.8 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1½ billion lower than estimated at Budget time. CGBR (unadjusted) estimated to be £5.3 billion in the first 5 months of 1982-83.