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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 BRIEF

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

M M Deyes

M M DEYES

RIA

R I G ALLEN

15 October 1982

EB Division
H M Treasury
01-233-5503

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

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

2. 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. Recovery Over?

Delayed but not over. Activity still 1 per cent above trough in Spring 1981. Pause this year largely reflects external developments. Expected recovery in world trade and growth expected at Budget time has not materialised.

4. Recovery next year?

Prospect remains for resumed modest recovery next year - supported by most outside forecasters. [NB. Next Industry Act forecast will be published later in Autumn.]

5. Where will growth come from?

Sources of growth are expected to be :

- some modest recovery in world activity;
- a recovery in confidence as inflation prospect improves;
- fall in interest rates improves companies' financial position and encourages a revival of fixed investment and stockbuilding;
- increased consumers' expenditure as the result of lower inflation.

6. Government policies have caused recession by deflating demand?

No. Output had fallen more strongly than demand during the current recession; and in year to 1982 Q2 real demand rose by 3 per cent, real output by only 1 per cent. Import penetration rose 10 per cent last year. 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.

7. What factors have caused flattening out in recovery this year?

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 - inflation and interest rates coming down fast - and will contribute to future recovery.

8. Tighter than expected fiscal policy to blame?

Fiscal policy stance 1982-83, so far as can be judged at this stage, consistent with Budget judgement. Monetary aggregates also on target. Undershoot on PSBR last year contributed to strong fall in interest rates - down 6½ percentage points since last autumn. (See also Section H).

9. Business confidence collapsed?

Business sentiment at present difficult to assess. Certainly cannot discount recent gloomy reports from West Midlands and Association of British Chambers of Commerce. But different surveys cover different samples and ask different questions. CBI asks its members about changes in optimism compared with four months previously. The Times Business Forum, covering most major companies as financial institutions recently posed a question about the level of optimism and it showed a remarkably high level of optimism on prospects for company growth/profits over next two years. [NB Next CBI Survey due to be published on 26 October].

10. Recent interest rate/monetary developments?

Steady reduction in UK rates made possible by satisfactory developments in main monetary aggregates, exchange rate, strength of and progress on inflation. (For further material on monetary developments, including bank lending, see section J.)

11. Who benefits from lower interest rates?

[Personal sector as a whole is a net asset holder and will lose; so will any companies which are similarly placed].

Home-buyers and the company sector will benefit from lower interest rates. Each 1 per cent reduction in interest rates eases companies financial position by £250-300 million over a full year.

[IF PRESSED: not all personal sector gains but first time house-buyers whose financial position is often difficult will benefit substantially].

12. Public spending cuts? Think tank report?

See E3

13. Unemployment trend worsening?

See C3.

14. Poor prospects for world economic recovery?

See T1 .

15. Is there an impending world financial crisis?

See T4.

16. Autumn Statement?

[Government's reply to Report on Budgetary reform from TCSC 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 TCSC'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.

BULL POINTS As at 15.10.82

(i) Activity. Underlying level of output broadly flat since last Autumn but industrial and manufacturing output above levels spring 1981. Most recent major independent forecasts see prospect of modest recovery later this year and next.

(ii) Interest rates. Bank base rates have fallen 6½ points since last autumn (now 9½ 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. The increase in the RPI over the 12 Months to September was 7.3 per cent. This is the lowest since September 1972 and close to a quarter of the peak level of 26.9 per cent in August 1975. The September level of prices is no higher than June and actually below the August level - the first fall since August 1970. Prospect of annual rate RPI inflation 6½ per cent by end of 1982. Manufacturers' output prices up 7½ per cent in year to September.

(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 1981-82 round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in 1980-81 round.
- Manufacturers' unit wage and salary costs up only 5½ per cent up in year to July, below average of major competitors.
- Manufacturers' input prices up just 3¾ per cent in year to September.
- CBI August 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 9 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 1/3 worse than in 1975.

(vii) Profits: Industrial and commercial companies' gross trading profits (net of stock appreciation, excluding North Sea) risen 16 per cent in 1H 1982 compared with 1H 1981. Recovery in profits from very low base: pre-tax real rate of return of ICC's (excluding North Sea) only 3 per cent in 1981.

(viii) Housing starts (total) - up over a quarter in first eight months of 1982 compared with same period 1981.

(ix) Exports (non oil, excluding erratics) only 1 per cent lower in 12 months to August 1982 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 (started 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-September 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/output about 1 per cent higher than in Q2 1981. Industrial production in three months to July unchanged compared with previous three months once adjustments made for holidays in May and June. Underlying level of industrial output 1½ per cent above 1981 Q2 trough - largely attributable to North Sea oil. Trend in manufacturing activity at best flat and may be deteriorating.]

Prospects for recovery this year undoubtedly receded since Budget, particularly since world recovery has not materialised. But rapid progress on inflation and interest rates, and productivity is higher. Beginnings of recovery in industrial competitiveness must not be undermined. Industry's contribution to sustaining recovery is decisive; must be ready to meet (modest) recovery in world activity expected next year (see T1).

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 7) and net balance of firms reporting excess stocks unchanged. 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 ½ per cent up on 1981].

CBI September Monthly Trends Enquiry and latest forecast further confirmation of flattening out in activity since last autumn. Government always maintained recovery would initially be 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.

[NB Next CBI trends survey to be published 26 October].

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 quite 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. Stock levels a threat to recovery?

Falling interest rates (nominal rates lowest for four years) have eased cash pressures and should assist recovery in stock cycle.

6. Competitiveness not improved this year?

Competitiveness improved 10-15 per cent during 1981 [but remains one third worse than in 1975]. Further improvements, which are essential to regain markets and create new ones, depend above all on substantially lower wage settlements in this pay round than in the last one.

7. Productivity growth falling off?

No; productivity growth in manufacturing at 6 per cent over last year is well above the UK historical average.

8. 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.

9. FSBR forecast now looks too optimistic?

[Several independent forecasts have revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about ½-1 per cent), largely reflecting the recent disappointing levels of world trade. Despite this most groups have not altered their assessment of the strength of the recovery 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 are doing much better than expected on inflation and interest rates. Clearly there are uncertainties, not least the international environment - though some indications that worst of recession is over in US (see T19). At present there is no reason to doubt that gradual recovery will resume in 1983. Certainly the majority of outside forecasters do not doubt it.

10. Latest Industry Act forecast

Next publication of Treasury forecasts will be in autumn.

11. Outside forecasts

[GDP profile in recent major assessments:

Per cent change

	NIESR (May)	LBS (June)	St James (Aug)	Phillips & Drew (Oct)	Simon & Coates (Oct)	CBI (Aug)	OECD (July)	FSBR (March)
1982 on 1981	+1	+1	+1¼	+¾	+½	+½	+1¼	+1½
1983 on 1982	+1	+3	+2½	+2	+2½	+1½	+1¾	+2

Nearly all see prospect of continued recovery and lower inflation.

C LABOUR MARKET

1. Government concerned over unemployment?

Of course Government is concerned, and so is pursuing balanced fiscal and monetary policies to curb inflation, and creating conditions for enterprise - the only measures that will ensure sustainable increase in employment. Nevertheless Government has substantially increased spending on schemes to alleviate impact on especially vulnerable groups - e.g. 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 1982-83; 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.

2. Cost of unemployment? Effect on PSBR

There can be no single estimate of 'the cost of unemployment'. Only costs that can be at all readily identified are additional expenditure on unemployment benefit, supplementary benefit, rent and rate rebates and administration. (Even these dependent on characteristics of those becoming unemployed - family status, resources etc). These could average £1800 in 1982-83 for each additional registered unemployed person. (NB This cannot be multiplied out by the total number unemployed.)

[IF PRESSED: Estimates of effect of other influences on PSBR directly or indirectly associated with unemployment vary widely depending on large number of highly debatable assumptions. And a major change in the level of unemployment would have impact on other economic indicators effective in the calculation of PSBR.]

3. 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. 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, roughly flat for last 6 months.

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 levelling out in activity since last autumn.

4. Unemployment in UK higher than in other countries?

[On standardised definitions in Q1 1982 UK unemployment was 12.7 per cent compared with 8.0 per cent OECD rate; little over doubling for UK compared with OECD rise of over one half since 1979.]

Unemployment now rising very fast in many industrialised countries - much faster in some e.g. Netherlands, Belgium and Canada.

5. UK's true unemployment figures really much higher?

[Sunday Times 19 September suggested 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.

6. 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 a worsening in the underlying trend in unemployment since June this year, rise for year as a whole has only been some 40 per cent of rate over same period last year. Employment situation should benefit from some further recovery in activity.

7. Fiddling the statistics?

[Rayner cost-saving exercise means that from November onwards method of measuring unemployed will change. November count will be some 100,000 lower than on traditional measure. Even further reduced in summer when school leavers register.]

No question of a fiddle. Detailed and considered study revealed substantial savings on collecting statistics for registered non-claimants. D.Employment will be providing estimates of effect on past statistics, and will provide similar information for up to a year from the change.

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

Government does not publish such a forecast. Nor did its predecessors. Unemployment depends on many factors: labour supply changes, growth in output and real earnings - all difficult to predict

IF PRESSED: in early 1980 no major outside forecasters accurately foretold fall in manufacturing output nor dramatic labour 'shake-out' of 1980-early 1981.

9. 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.

10. 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.

D TAXATION

1. Burden of taxation

[Total taxation (including NIC) as proportion of GDP was 34½ per cent in 1978-79 and is forecast to be 39¾ per cent in 1982-83. Corresponding figures excluding NIC are 28½ per cent and 33 per cent].

Burden has inevitably risen because of upward pressures on public expenditure caused by the recession. Increases in taxation are better - and more honest - means of financing this than borrowing, because of adverse effects borrowing has on interest rates and inflation.

2. British tax burden high by international standards?

Not so. Accurate comparisons difficult, but UK burden about average for OECD countries [1981 data from Lloyds Bank Economic Bulletin, October 1982]. Similarly, UK taxes on household income and employees' social security contributions about average for EC countries and lower than Japan and USA [1980 provisional OECD data].

3. Prospects for cuts in taxation in 1983 Budget?

[Reference Chancellor's speech to Conservative Party Conference 6 October and Weekend World interview 10 October].

Cannot, of course, comment now. Progress on inflation and interest rates must be maintained. Remain committed to tax reductions, but these will be made only when they can be afforded.

4. Previous reductions in personal taxation favour the rich?

1979 Budget cut absurdly high top rates of income tax to European levels, as part of package which also involved substantial increase in thresholds. Such action was essential to restore incentives. No 'pot of gold' in higher rate tax; restoration of 83 per cent top rate would finance a cut of under ¼p in the basic rate.

5. Burden of taxation risen most for the poor?

Proportion of income paid in income tax and NICs has fallen in 1982-83 for lowest paid taxpayers. Low paid with children are also entitled to benefits such as FIS.

6. Poverty and unemployment traps

Government equally concerned about poverty and unemployment traps, in context of incentives as a whole. They will remain a key factor in considerations of future tax policy. Traps are essentially caused by measures to relieve poverty and unemployment. Substantive action to alleviate them through the tax system would be extremely costly. Long-term solution must be an increase in wages as a result of a sustained improvement in economic performance.

7. Further reduction in NIS?

This year's reduction will benefit private sector by £640 million in 1982-83. In addition, employers have been shielded from increases in NIC rates over last two years. Cannot comment on possibility of further reductions, which would be expensive.

8. Further action to encourage wider share ownership?

Already seen encouraging growth of employee share-ownership, as result of liberalisation and extension of arrangements to promote profit sharing and share option schemes in 1980 and subsequent Finance Acts. Total of almost 500 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979.

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. Higher figures quoted in Weekend World programme 10 October?

[Ratio of public expenditure planned for 1982-83 to GDP in that year given in Weekend World programme was 46.8 per cent. Apparently derived (incorrectly) by someone at ITV taking from the FSBR the wrong numerator for the ratio. They took it from Table 8. The correct figures were given in the FSBR at para 2.21, and a reconciliation set out in Table 6.]

Figure of 46.8 per cent shown on Weekend World for 1982-83 based by them on incorrect calculation. The estimated ratio of public expenditure to GDP in 1982-83 is 44.5 per cent - which compares with 46 per cent in 1975-76 before Mr Healey went to the IMF. As Chancellor said, the intention is to reduce the ratio of public spending to GDP and it could be down to 41 per cent in 1984-85

4. Longer-term outlook for public expenditure?

[Economist 18-24 September reported that radical CPRS proposals to cut public spending in the longer term were tabled but not discussed at Cabinet 9 September.]

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. No necessarily questions of 'decimating' services; rather of finding best ways of financing better quality with wider choice. No specific decisions have been taken as a result.

5. 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.

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

Bids for additional expenditure 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.

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

Government 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. Moreover nationalised industries financing an increasing proportion of investment out of own resources. Also, since mid-1970's some needs have declined; future standards and public amenities will not be jeopardised.

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

Government prepared to give priority to worthwhile capital projects within overall totals. But no question of artificial and inflationary stimulus to demand. New projects must be considered on merits. Nationalised industries investment in 1982-83 planned to be about quarter higher than 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.

9. 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.

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. 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 limits varies and is governed by 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.

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

Number of reasons including lower tender prices working through. But overwhelming reason was success in selling council houses and unused land.

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.

14. 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.

15. 3½ per cent pay assumption for 1983-84?

[Announced from Treasury 10 October.]

Assumption is not a 'norm'. Nor is it a decision on the offer to be made in any particular case. Each will be considered on its merits. It concerns the provision in public expenditure plans for next year for those groups for which Government is directly responsible, other than NHS. It does not directly cover local authorities, or nationalised industries, which are not within Government's direct control. But they will be controlled by the rate support grant and the external financing limits.

16. 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 (see F4) in due course.

LOCAL GOVERNMENT

17. 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.)

18. 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.

19. 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.

20. 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.

21. Proposals for direct control of local government spending?

Local authority overspending shows that the traditional consensus with central government is breaking down. We cannot afford to let damaging levels of expenditure continue unchecked. Local authorities' own irresponsible behaviour may force us to consider more direct action.

22. 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

23. 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.

24. 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.

25. 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 £1 million 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.

26. How will the various costs be met?

Intention is to try to absorb 1982-83 extra costs within the Contingency Reserve. How future years' expenditure is to be funded will depend on decisions in this year's 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.

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

[Published 13 September. Some very large possible spending figures being bandied about by media]

Report will need careful study, both in UK and the Falklands, before decisions on all these proposals are reached. In advance of 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 efficiency?

[Government reply to TCSC was published 28 September entitled 'Efficiency and Effectiveness in the Civil Service:Government Observations on TCSC Report Cmnd 8616].

Measures to increase efficiency in civil service set out in Government's recent White Paper welcoming Report from TSCS, and accepting (totally or with reservations) no less than 20 of the Committee's 26 recommendations. White Paper gives details of new financial management initiative, and responds to Committee recommendations on management information systems, training in management and financial management, and the filling of senior posts.

3. Civil service pay in 1983?

Unions have asked Government, in light of 3½ per cent planning assumption announced 1 October (see E 15), whether Government intend to have genuine negotiations, and whether arbitration will be available. They believe arbitration should be unconditionally binding ie not subject to Parliamentary over-ride.

4. Megaw Report

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. Preliminary 'ground-clearing' discussions with unions have commenced. (See also E16.)

4. Scott Report/Public sector pensions?

See K 17.

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.]

Our position on this has been made clear. We reviewed the possibility of restoring the abatement when the benefit was brought into tax in July, but concluded that we could not afford to do so. The matter is being kept under review, and I have nothing more to add.

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 in National Insurance contributions?

We are currently in the early stages of the annual review of national insurance contributions conducted by the Government Actuary. It is too early to say what that review will produce.

6. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analysed 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 year 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 are 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.

8. Uprating benefits - will Government claw back any overshoot?

[Most benefits will be uprated by 11 per cent on 23 November. 9 per cent of this is to compensate for price increases over previous year].

Inflation is falling faster than was forecast at Budget time and we expect the outcome to be lower than the 9 per cent forecast. We shall not know the extent for a couple of months yet. This November's uprating will of course go ahead as planned. The 1983 uprating will be decided nearer the time. It will depend on the forecast movement in prices which will be made at Budget time, and whether the Government decides to take account of any overshoot this year. No decision has yet been taken.

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 K2-3). Long term interest rates now lower than at any time in last 9 years. Benefits seen in recovery of debenture market. [IF PRESSED: Government would like to see rates lower still, so long as further reductions not likely to endanger progress or inflation.]

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. France demonstrates problems with reflation option and US experience shows that fiscal and monetary policy must be broadly consistent.

3. 1981-82 undershoot shows fiscal policy too tight?

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

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 (6½ percentage points down since last autumn). Recovery of corporate bond market shows how lower PSBR creates room for investment.

4. 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.

5. 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.]

Too early to say. Some of factors responsible for undershoot last year may indicate lower PSBR this year (eg higher income tax receipts). But other factors could go other way -

pressure on Contingency Reserve from Falklands spending, changes in estimated NI contributions, lower prices reducing VAT. [NB. PSBR for September quarter to be published 21 October. NOT FOR USE. Likely to indicate cumulative PSBR April-September of about £4.6 billion].

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

[CGBR September £0.3 billion; April-September inclusive £5.6 billion,compared £9.7 billion for same period last year].

CGBR figures so far not in consistent with £9.5 billion PSBR forecast. Comparisons with last year (distorted heavily by civil service industrial action) can be very misleading. (Also change in rules for local authority borrowing cause switch from Local Authority Borrowing Requirement to Central Government Borrowing Requirement with no effect on PSBR).

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

Link between PSBR and interest rates not a mechanical one. Moreover, 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.

8. 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 have to be financed and influence interest rates and aggregate demand.

9. 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, 1.1 and 0.9 per cent respectively in banking September. These changes bring rates of growth in the 1982-83 target period to 9½, 11½ and 8½ per cent per annum respectively, compared with target range of 8-12 per cent (all figures seasonally adjusted).]

Rates of growth of all three target aggregates are within Government's target range. £M3 is towards top of range. But looking also at behaviour of exchange rate and progress in reducing inflation, overall picture is of sound domestic monetary conditions.

2. Prospects for further reductions in interest rates?

[Last reduction in bank base rates made on 13 October to 9½ per cent. Have come down by three points since early July.]

Substantial interest rate reductions this year reflect sound monetary conditions, and good inflation prospects. Impulse also from US developments. 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, and again this month.]

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. Increased by £1.3 billion in banking August and £2 billion in September (seasonally adjusted).]

Reasons for growth of bank lending to companies not entirely clear. Companies may be trying to build up gross liquidity levels which fell back in spring. Personal lending also quite strong. Growth partly the result of structural changes, such as move by banks into home loans market, replacing lending by building societies. Ending of HP controls in July does not appear to have had a large effect.

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 25 June. BOC announced issue of £100 million conventional bond 10 September.]

Zeros broaden options available to companies, though not expected to transform captial 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 of from banks and by broadening options available to companies issuing their own debt, and so reduce levels of assistance required.

K PRICES AND EARNINGS

PRICES

1. September RPI

[Year on year increase in RPI 7.3 per cent in September, compared with 8.0 per cent in August].

Annual rate of inflation fell sharply in September to 7.3 per cent, its lowest level for 10 years (compared 7.0 per cent in September 1972). The price level in September was no higher than in June and actually slightly (0.1 per cent) lower than in August - the first time the index has fallen for 12 years (since August 1970).

2. 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.

3. Further falls likely in 1983?

We expect continued progress in reducing the rate of inflation in the new year.

4. 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 12.8 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (September 1982) 7.3 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.

5. Inflation still not as low as competitors?

[August figures: UK inflation 8.0 per cent compared with 5.7 per cent in US, 5.1 per cent in West Germany, and 3.1 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.

6. 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.

7. TPI now shows pay increases need to be ½ per cent higher than RPI to maintain living standards?

[Increase in TPI over 12 months to September 7.9 per cent, compared with RPI increase of 7.3 per cent].

The gap between the RPI and the TPI (now 0.6 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.

8. Nationalised industry prices

[Increase over 12 months to September 13.7 per cent, compared with RPI increase of 7.3 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 6 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; for gas price rise in October see R2).

PAY

9. A 3½ per cent pay policy?

The 3½ per cent pay assumption [announced 1 October for calculating the pay element in cash expenditure plans for 1983-84] does not represent a 'norm', still less an 'incomes policy'. Nor is it a decision on the offer to be made in any individual case. Settlements higher or lower than the assumption are not ruled out. Each case will be considered on merits.

10. 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.

11. 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.

12. 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.

13. 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.

14 NHS pay

Discussions are still continuing with Royal College of Nurses and other professional bodies on proposals for two year settlement. Disappointing that TUC unions unwilling to participate in these talks.

15. 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.

16. Average earnings index

[Year on year growth 10.9 per cent in July 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.

17. 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

[August 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 £2.1 billion in eight months to August.]

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 be holding up better than expected given the poor level of world trade.

3. Import trends

Manufactured imports increased in August but were still below their high May levels. The underlying level of manufacturing imports has probably not altered since end-81 when manufacturing activity levelled off.

4. Figures for 1981

Only the 1981 August export figures now remain to be published. These should become available shortly.

5. 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

[The average £ effective rate in Q3 1982 was nearly 10 per cent lower than in Q1 1981. In last few months £ has remained broadly stable. Rates at noon on 153 October were $1.7030, DM 4.2955 and an effective of 92.78. Previous lows were $1.6821 on 5 October, DM 4.098 on 21 May. Highs were $1.97 on 30 November 1981, DM 4.407 on 9 February. Reserves at end September stood at $18.3 billion, compared with $18.1 billion at end August.]

Government has no target for exchange rate. The exchange rate is only one of the factors taken into account in interpreting domestic monetary conditions and taking decisions on policy. Sterling's effective exchange rate has continued to show the broadly stable pattern of recent months. This stability reflects the continuing international confidence in this Government's economic policies.

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. 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.

2. 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.

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. Will Government withhold contributions?

We hope very much that the issue of our Budget contributions can be satisfactorily settled without the need for recourse to such a step.

5. 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.

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

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

EUROPEAN MONETARY SYSTEM

8. 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.

9. 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. Prospects for industry-recovery?

See A 3-5 and Section B.

2. Companies' financial position?

[

						£bn
	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.

3. 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 improvement in ICC's rates of return depend on better performance by companies. Some encouragement from recent productivity gains and trend towards moderate pay settlements.

4. High interest rates damaging for industry and investment?

Banks' base rates have fallen 6½ percentage points since last October, and 3 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 £250 million over a full year. Lower interest rates reflect Government's firm fiscal and monetary stance and will help industry and investment.

5. 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.

6. Government help for small firms

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

7. Response to Loan Guarantee Scheme?

[Over 6,400 guarantees already issued - about half to new businesses. Total lending under scheme around £215 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, out of over 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.

8. 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 (13.7 per cent in August compared 7.3 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 artifical 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 [6] 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. Increase in gas prices?

[Domestic gas prices increased on 1 October. Some Press speculation that industry will have to pay 1p per therm more each quarter as contracts come up for renewal next year]

Large increase in domestic prices over last three years needed to remedy under-pricing by previous Government. There will be no more massive increases in gas prices. Industrial gas users have benefited from two years of virtual freeze on renewal prices for contract gas. BCG not yet decided on pricing strategy following lifting of the freeze at end of this year.

3. 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

4. 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.

5. 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.

6. 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.

7. 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.

8. 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

9. 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

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). True that 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 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'.

11. What further sales expected?

Special sales of assets in 1982-83 forecast at around £600 million and expected to increase in subsequent years. This year's and next year's involve primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - 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.

12. 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. To that end the Energy Secretary has laid an Order which will transfer the 100 per cent shareholding in Britoil to his ownership on 1 November.

13. 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.

14. 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 and crucially dependent on inherently uncertain cost, price and production assumptions. Prospects for North Sea revenues have improved since FSBR published because of higher than assumed oil prices. Higher 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 present 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 134) 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. Energy Secretary and Chancellor replied in joint memorandum 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 markets 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 BNOC.

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. Prospects for world recovery?

[IMF, London Business School and Bank of England Quarterly Bulletin all gloomy about immediate prospects. No overall growth seen in major countries in 1982, and only weak recovery next year. Press reports suggest OECD will also revise its previous forecasts this autumn.]

Output in the major economies appears to have recovered slightly in the spring after the downturn last winter. Latest estimates suggest further growth in US economy in the most recent period. The major European economies, however, remain depressed, and it is too early to say that a broad upturn has started. Lower inflation and interest rates however offer prospects for better growth next year.

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

Leaders of the major countries agreed at the OECD, Summit and IMF meetings on the need to continue the fight against inflation. As the OECD's Economic Outlook explains, 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'.

3. ~~Anti-inflation~~ policies are working

[Inflation down from a year ago in all 7 major economies on latest available figures: US (from 10.7 to 5.9 per cent), UK (11.6 to [8.0] per cent), Japan (3.8 to 3.1 per cent), Italy (18.3 to 17.2 per cent), Canada (12.7 to 10.5 per cent) France (13.8 to 10.2 per cent), Germany (6.5 to 4.9 per cent).]

Inflation has fallen in all major countries in the past year. Firm fiscal and monetary responses to 1979-80 oil price rise vindicated. UK close behind US and Germany in bringing down inflation, and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures.

4. International financial collapse?

Concern about effects of over-borrowing noted at Toronto IMF meeting. But should not exaggerate alarm. Important of course to sustain system's stability. Lower interest rates should help, as should IMF programmes to restore countries' credit-worthiness. Further progress needed on banking supervision including risk assessment and prudential standards; also watertight allocation of supervisory responsibilities.

5. What about US ideas for emergency IMF assistance to countries heavily indebted to the international banking system?

The IMF must certainly be endowed with the resources it needs to carry out its present role. There is widespread agreement that a substantial increase in its quotas is necessary. Its resources may need to be supplemented even further. The US ideas are only one of a number which need to be studied carefully.

6. 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 1 September. Borrowing ceiling set at 3 per cent of GDP. Government has also announced increases in duties on tobacco and alcohol, and delays in planned increases in some social payments, including pensions].

Strength and stability of world economy will benefit if all countries can control inflation. So we welcome French government's commitment to reduce inflation and to rein in Government borrowing.

7. Japanese reflation?

[Japanese Government have introduced reflationary package of £4½ billion (Y 2020 trillion) or just under 1 per cent of GDP. Mainly consists of increased expenditure upon public works in current fiscal year.]

Inflation in Japan only 3.1 per cent; unemployment 2.3 per cent; savings high. Different conditions from UK.

8. US Budget?

[Despite package of tax increases totalling $98.3 over next three years, passed in August, US budget deficit for 1982 expected to be about $109 billion; deficit for 1983 forecast to be even larger].

Welcome Congress approval of tax package. US has won a battle but long campaign lies ahead to put deficits on convincing declining path in medium term.

9. US monetary policy

[US interest rates have fallen and Federal Reserve has reduced its discount rate from 9½ to 9 per cent. Chairman Volcker has said US authorities will be 'attaching much less than usual' weight to M1 over period ahead].

Accept that monetary indicators in US must be interpreted flexibly in light of financial innovations. Federal Reserve Chairman, Mr Volcker has made clear that reduction of inflation remains a priority and that monetary targets have not been abandoned.

10. US economy?

[US GNP rose slightly in Q2 after falls of more than 1 per cent in preceding two quarters. Preliminary indications suggest that GNP may show a further small rise in Q3. Unemployment has risen above 10 per cent. Consumer price inflation has fallen to 5.9 per cent. Tax cuts effective, July were expected to boost consumer demand but retail sales and industrial production remain flat. Interest rates, however, have fallen 4½ per cent since July].

US output rose slightly in Q2 and preliminary indications suggest that there may be a further rise in Q3. Still too early to say that a strong recovery is under way, but falls in interest rates and infaltion hold out better prospects for growth over the next year.

11. Another oil energy crisis looming?

[Latest World Energy Outlook from International Energy Agency raises possibility that tight oil market could reappear in late 1980's].

Always difficult to foresee future oil prices. But they are weak at present and likely to remain so ~~in~~ near future. In longer term, energy conservation should permanently reduce countries' dependence on oil.

Aide Memoire on Recent Economic Developments and Statistics: 15 October 1982

Summary comment

Financial developments in UK generally favourable but both nationally and internationally gloomy statistics have been published on "real" variables over last few months.

World Economy - expectations held by most forecasters for an upturn in activity this year have not been fulfilled; the 1 per cent expected recovery has not materialised.

- world trade has been more or less flat since the middle of last year.

- total industrial production in the twelve months to June fell 4.8 per cent in the OECD Major 7 and by 10 per cent in the US.

- inflation (major 7) around 7 per cent in August: ranging from 17 per cent in Italy to 3 per cent in Japan.

- three month interest rates for the "world basket" stood at 11.35 in October a fall of 4 per cent on the 1981 Q3 average; Real interest rates remain clearly positive.

- OECD 7: unemployment increased from 6.4 per cent in 1981 Q2 to 7.8 per cent in Q2 this year.

UK Balance of Payments - the non-oil trade balance has deteriorated quite sharply but because of oil exports, the current account is just in balance.

- OPEC and Third World countries are cutting back on imports because of low commodity prices and debt problems in some countries. UK exports are substantially down in the last three months.

- imports rose sharply as activity recovered last year and import penetration rose too. it remains high this year.

- capital account: identified capital movements were roughly in balance in the second quarter; a turnround of £80 million on the first quarter.

. the effective exchange rate has been steady at around 90 for a year now; currently 91.8.

Financial Developments: monetary targets and PSBR are within the target ranges; interest rates down 6½ points since October.

.M1, £M3, PSL2 within target range for 1982-83, M1 highish.

.interest rates down 6½ points since last October;

.PSBR remains within the FSBR forecast of £9½ billion for 1982-83.

Inflation: inflation responding favourably (but it is in other major OECD countries too).

.retail price inflation 7.3 per cent in September. Forecast 6½ per cent before Xmas;

.WPI also behaving well; 12 monthly increase 3¼ per cent to September; (but not susceptible to specific influences, like mortgage rates, influencing RPI;)

.TPI increase in 12 months to September was 7.9 per cent.

Gross Domestic Product and Output

.money GDP growth slowed by 1 per cent to 8½ per cent per annum in the first half of 1982; during 1981 the rate of increase was about 9½ per cent;

.GDP has been broadly flat since 1981 Q4 as has the underlying level of industrial production;

.increased North Sea oil and gas production is offsetting a 1 per cent reduction in manufacturing output since 1981 Q4.

Demand Components

.consumer spending has remained broadly unchanged since 1979, over a period when other components of final demand fell some 4-5 per cent. Retail sales in July and August were a little higher than in previous months but slowed again in September.

.gross fixed investment fell back by 4 per cent in 1982 Q2 - from a strong first quarter - to a level similar to that in 1981 H1 and 10 per cent below the level in 1979. Manufacturing investment has been weak. Plant and machinery investment, however, has held up quite well in relation to output.

.the massive destocking of 1980 H2 and 1981 is over but the 1982 Q2 figures show no return to positive stockbuilding. September CBI survey suggests some further scope for destocking;

.government consumption as a proportion of GDP is on-plan.

.there has been some fall in the volume of exports in recent months reflecting both loss of competitiveness and the slow-down in expected world trading activity;

.imports rose very sharply between the two halves of 1981, reflecting both the increase in activity and increased input penetration (this remains high in 1982).

Productivity and Competitiveness

.manufacturing productivity continues to rise strongly - a 5 per cent annual rate so far this year, following 8-10 per cent last year. Still high by historical standards;

.unit wage/salary cost up only 5 per cent in last 12 months;

.during 1981 our external price and cost competitiveness improved at least 10 per cent but this year little or no further improvement has emerged.

Company Sector

.after falling in the first quarter of 1982 gross trading profits (net of stock appreciation) of ICCs rose by 5 per cet;

.non-North Sea profits in 1982 H1 were 22 per cent above their level in 1981 H1;

.gross profits of North Sea oil companies rose only 10 per cent over the same period;

.ICC's financial position (ex North Sea) in 1982 Q1 suggests a reduction in borrowing requirements compared to the second half of last year.

Personal Sector

.in 1982 H1 RPDI was about 1½ per cent lower than the average for 1981;

.wage settlements in 1981-82 were on average around 7 per cent, 2 per cent lower than in the previous round;

.underlying rate of increase in average earnings in year to July was about 9-9½ per cent.

Labour Market

.UK employment fell 2.2 million (10 per cent) between 1979 Q2 and 1982 Q1 (two-thirds concentrated in manufacturing); betwee 1981 Q1 and 1982 Q1 employers in employment fell by 800,000.

.first indications are that total employment fell more in the second quarter of 1982 than in the previous quarter.

.total registered unemployment rose by 50,000 to 3.3 million (14 per cent) in September;

.UK adult unemployment rose by 49,000 to 3 million (12.7 per cent) in September; trend since June is accelerating.

.vacancies have not altered much in recent months;

.other labour market indicators - short time, overtime - continue to suggest some flattening out on last year's improvements.

Forward Indicators

.seasonal falls in school leavers registrations occur after October but a sharp seasonal rise in unemployment occurs in January;

.the volume of new construction orders, which increased strongly in the first half of 1981, hs subsequently remained broady flat. Within the total, orders for new housing, particularly in the private sector, have weakened since last spring. Engineering orders have also failed to pick up during 1982.