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# CABINET

## ECONOMIC PROSPECTS

### Memorandum by the Chancellor of the Exchequer

The short term prospects for the economy are broadly similar to those foreseen at Budget time. The temporary rise in inflation has gone slightly further than was then envisaged and output is rather more buoyant. But the inflation rate is still expected to subside in the second half of the year and 1986 should see continued growth and significant progress towards lower inflation. The main risks overseas, as ever, concern developments in the US economy and the oil market. At home they concern the upward drift in earnings and the pressures which will arise if we fail to hold expenditure to its present plans.

THE WORLD

2. The major 7 economies are likely to grow at around 3% this year and next, with inflation averaging about 4%. World trade - on a UK trade weighted basis - may increase more slowly than the 7-8% achieved in 1984; about 5-6% this year and next. Some overseas markets of importance to the UK (particularly the oil producers) are expected to reduce their imports.

3. In the US, there has been little real progress on the federal deficit. But though output growth has slowed down, domestic

demand is still reasonably strong. A lower dollar is likely. The US current account deficit seems likely to persist and there are dangers from the growth of protectionist pressure.

4. The world oil market remains in a fragile state. Some fall in the world price seems likely, and a sharp fall a possibility.

THE BRITISH ECONOMY

5. At home the prospects continue to look reasonably good. We have now embarked on our fifth year of continuous growth in national output, and can look forward with some confidence to a sixth. Boosted by the rebound after the coal strike, output should rise by 3½ per cent this year and perhaps by a further 2½ per cent in 1986. This would be a commendable performance, bearing in mind that North Sea output is likely to start falling next year.

6. The expansion is broadly based. Real personal disposable incomes should grow by 2½-3% this year, resulting in rising personal spending. This could be faster next year as inflation falls.

7. Company profits have recovered substantially. The 1984 rate of return for industrial and commercial companies (excluding North Sea oil) was as good as at any time since 1973. (If oil is included, it was the highest since records began in 1960.) Business fixed investment is likely to remain strong in 1985 and should rise further in 1986. But there have been further economies in stockholding in the first quarter of this year. Overall, domestic demand may rise by 2% in 1985. Exports of goods and services seem to be more than holding their share of world trade and are expected to rise by 8%, after 7% growth last year. In 1986 the balance might change to 3% growth in

both domestic demand and exports.

8. The recent increase in the RPI is expected to be temporary but the peak (probably in July) will be about 1% higher than was forecast at Budget time. The recovery in the exchange rate since February this year, and the prospect of a steadier, and perhaps falling, mortgage rate will result in lower inflation probably from August onwards, falling to 5¾ per cent by the fourth quarter (compared with the Budget forecast of 5 per cent) and under 5% this time next year.

9. A continuing high level of pay settlements makes progress on employment more difficult. It does not look as though there will be any decline in private sector settlements in the coming pay round. Indeed, there is some risk of a further increase. So although the forecast assumes continued tough bargaining in the public sector with public service earnings rising more slowly than in the private sector, pressures for closer parity with those in the private sector will undoubtedly increase.

10. Against this background, the prospects for unemployment are uncertain. Total employment is estimated to have risen by 600,000 between March 1983 and December 1984. This rise is more than accounted for by increases in part-time employment and self-employment. The number of full-time males in jobs fell. And as many of the new jobs have also been taken by new entrants to the labour force, unemployment has continued to rise: it is too soon to draw any conclusions from the encouraging figures for June. The unemployment statistics almost certainly overstate the number of people looking for jobs; a considerable proportion of the claimants who have been unemployed for a year or more are not actively seeking work. But, although the employment measures announced in the Budget have not yet had time to make any significant impact, the fact that demographic changes will add ½% to the labour force over the next two years

means that a substantial drop in the unemployment count is unlikely.

11. Turning to the financial picture, the extreme nervousness in the financial markets at the turn of the year has been overcome. But there is no scope yet for relaxation. We must continue to demonstrate to a world in which most major countries have lower inflation than us that we are determined to maintain sound financial policies and that they are consistent with bringing inflation back to a downward trend.

12. Despite some fall in North Sea oil revenues, we remain on track for the £7 billion PSBR set for 1985-86 at the time of the Budget. But to avoid any overrun on borrowing (and hence upward pressure on interest rates) we must ensure that we keep to our spending plans, both in the current and future financial years. The Chief Secretary's paper makes clear that the pressures for higher public spending remain intense. It will require great determination to maintain the firm control of expenditure which is central to our economic strategy and essential if we are to maintain any hope of reducing the tax burden, particularly given the uncertain prospect for oil revenues.

13. A summary of the most recent Treasury forecast is in the attached table.

CONCLUSION

14. In most respects, the economy is doing well. Output and employment are rising, though unemployment is not yet on a downward trend. Inflation is set to resume its decline. But there are dangers. We may have to be in a position to withstand a sharp change in the dollar, or the oil price. And we have a good way to go to match the inflation performance of our more successful competitors. At home, we face upward pressure on

earnings growth with the consequent problems for employment. We must not add to these hazards by allowing public expenditure to increase beyond our plans.

15. The burden of taxation and national insurance contributions is still substantially higher than it was in 1978-79, despite a small reduction in the last Budget. Further progress towards reducing the tax burden must be made, both for the sake of employment and to maintain political credibility. If we are to secure those reductions it is essential that we agree to the Chief Secretary's proposals for the Survey. I urge my colleagues to do so.

N L

Treasury Chambers

8 July 1985

## MAJOR ECONOMIC INDICATORS

| | UK 1982 | 1983 | 1984 | 1985 (1) | OECD (2) 1985 major 6, excl UK) |
|---|---|---|---|---|---|
| **A** Demand and activity (per cent change on previous year) | | | | | |
| GDP | 2 | 3 | 2½ | 3½ | 3 |
| Domestic Demand | 2½ | 4½ | 2 | 2 | 3 |
| of which: consumer spending | 1 | 4 | 1½ | 2 | 3 |
| fixed investment | 6½ | 4 | 7½ | 3 | 5 |
| Exports of goods and services | 1 | 1 | 6½ | 8 | 7 |
| Imports of goods and services | 4 | 5½ | 9 | 3 | 7½ |
| **B** Inflation | | | | | |
| Retail prices, fourth quarter (per cent change) | 6¼ | 5 | 4¾ | 5¾ | 4 |
| Average earnings, fourth quarter (5) (per cent change) | 8 | 8 | 6½ | 8½ | 5½ (4) |
| **C** Other Indicators (levels) | | | | | |
| Current Balance (£ billion) | 5 | 3 | ½ | 4½ | -60 |
| Unemployment level (per cent narrow definition) | 11½ | 12 | 12½ | 13 | 7½ |
| Interest rates (3 month inter-bank per cent) | 12½ | 10 | 10 | 12½ (3) | 8 (3) |

(1) Figures consistent with SECRET Treasury summer forecast: figures quoted are CONFIDENTIAL

(2) US, Japan, Germany, France, Italy and Canada: Treasury forecasts

(3) Current level

(4) Manufacturing earnings only

(5) Not adjusted for the coal strike

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