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CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

Events this year are turning out rather differently from the prospect foreseen at the time of the Budget. The fall in inflation - both worldwide and in the United Kingdom - has gone further than expected. But output has grown more slowly, as the initial unfavourable effect of the oil price fall has been superimposed on a temporary pause in activity worldwide, with inevitable consequences for unemployment.

2. Although there is as yet no sign of it, a resumption of growth both abroad and at home still looks likely later this year, as the benefits to economic activity from lower oil prices begin to make themselves felt. But in the light of our experience so far this year we cannot afford to take chances. And however the prospects of world growth turn out, we face two particular threats at home: the failure of pay settlements to respond to sharply lower inflation, and the pressure for higher public spending, against the background of a fiscal position still vulnerable to the oil price which currently stands at under $10 a barrel as compared with the $15 a barrel assumed at the time of the Budget.

WORLD ECONOMY

3. Activity in the world economy was generally sluggish in the first quarter of 1986. There was a small fall in manufacturing output in Japan and much of Europe, and in the United States growth has been modest. Demand from outside the industrialised countries has also been weak, with a substantial reduction in imports by oil-producing countries.

4. With the collapse in oil prices and the continuing effect of the prudent financial policies pursued by all the major nations in recent years, there has been a further sharp fall in inflation: consumer prices in the major industrialised countries have risen on average by only 2 per cent over the past year. The consequent increases in real incomes, together with lower interest rates, should ensure a resumption of reasonably vigorous growth, perhaps later this year.

THE BRITISH ECONOMY

5. At home, the pattern has been broadly similar. Following its strong performance in the four years up to early 1985, output, adjusted for the coal strike, has since grown more slowly, and is now expected to grow at no more than 2½ per cent in 1986, instead of 3 per cent as forecast at Budget time. The prospect of buoyant consumers' expenditure and better exports reflecting the expected upturn in world trade should mean a somewhat stronger increase in activity in 1987 than was envisaged at the time of the Budget.

6. Inflation has fallen steadily for the past few months: as measured by the Retail Price Index it is now down to 2½ per cent. I expect it to remain low throughout the rest of this year and next year, although there will inevitably be some bounce back from the current artificially low level.

7. But this fall in inflation has been matched and often surpassed in other industrialised countries. Germany and Japan are now enjoying virtually stable prices. Moreover, there are clear signs in our competitor countries that the slowdown in price increases is being reflected in lower earnings growth; and their unit cost increases are negligible or negative.

8. In the United Kingdom, on the other hand, there is as yet no sign of lower actual and expected inflation being reflected in lower wage settlements. Earnings so far are continuing to grow at around 7½ per cent per year (as against an increase in the Tax and Prices Index of little more than ½ per cent) implying a sharp rise in our unit costs and a serious deterioration in our competitiveness.

9. The consequences of this excessive earnings growth are clear. Unemployment, despite all the measures we have taken, continues to increase at an average of 10,000-15,000 per month. With a faster expansion of employment as output growth picks up, and declining labour force growth, the best guess is still that there will be some improvement in the unemployment position next year. But excessive earnings growth is losing us jobs. Furthermore, the loss of competitiveness on our non-oil trade, superimposed on the deterioration in the oil account, is beginning to make the current account of the balance of payments look vulnerable.

10. Despite this the financial markets have so far been remarkably steady since the Budget. The exchange rate has held pretty firm in the face of a further fall in oil prices. Base rates have fallen by 2½ per cent and long-term rates have fallen to their lowest level since the early 1970s.

11. But both nominal and real interest rates remain high compared to those of our competitors. The major changes taking place in financial markets have made the task of interpreting monetary conditions very difficult. This has become something of a problem worldwide, but it is particularly marked in the United Kingdom. Although narrow money is towards the bottom of its target range, bank lending is expanding rapidly and broad money and particularly, but not exclusively, £M3 - continues to

grow well beyond expectations. In these circumstances, with no clear guideline for the markets to look at, our approach to interest rates must inevitably remain cautious.

12. Given these uncertainties on the monetary front, the markets are watching even more closely for any evidence of lack of resolution over the size of Government borrowing; and with the further fall in the oil price - which has been even more pronounced in sterling terms - the fiscal prospect looks more difficult than at the time of the Budget. As the Chief Secretary, Treasury's paper shows, the pressures for higher public spending are intense and relentless. It will require great determination to maintain the firm control of public expenditure which is central to our economic strategy and essential if we are to make further progress in reducing interest rates and avoid increases in the tax burden.

13. A summary of the most recent Treasury assessment is shown in the attached annex.

CONCLUSION

14. The economy has been experiencing a pause in the steady growth seen since the trough of the recession in 1981. That pause, which is also occurring in the rest of the industrialised world and has coincided with the collapse of oil prices, is affecting short-term employment prospects. But inflation has been lower than expected; and the prospect is still for a resumption of growth at home later on this year, as activity worldwide recovers its momentum.

15. But there are clear dangers. Developments in the world economy are inevitably subject to much uncertainty, and the failure so far of pay to adjust to sharply lower inflation is a threat to competitiveness, jobs and confidence in the financial markets. Against this background, we cannot afford to risk reversing the progress we have made in recent years in reducing the burden of taxation (still higher than it was in 1978-79), in reducing borrowing and in holding down inflation. It is vital, therefore, that we maintain, as the Chief Secretary, Treasury proposes, firm control of public expenditure.

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Treasury Chambers

14 July 1986

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ANNEX

MAJOR ECONOMIC INDICATORS

	United Kingdom 1983	1984	1985	1986	Summit 7 (excl.UK) 1986
A Demand and activity (per cent change on previous year)					
GDP	3½	2½	3½	2½	3
Domestic Demand	4½	2½	2	3	3½
of which:					
consumer spending	4	2	3	4	3½
fixed investment	5	8	1	4	4½
Exports of goods and services	2½	7	6½	1	1½
Imports of goods and services	6	9½	3	2	6½
B Inflation (per cent changes on a year earlier)					
Retail prices, fourth quarter	5	4¾	5½	2¼	½
Average earnings, fourth quarter	8	6½	7½	7½	3½ (2)
C Other indicators (levels)					
Current balance (£ billion)	3	1½	4	3	-6
Unemployment level (per cent, narrow definition)	12	12	12½	13	7½
Interest rates (3 month inter-bank, per cent)	10	10	12	10 (1)	6½ (1)
Sterling Index, 1980=100	83	78½	78	75 (1)	-
Oil prices, $ North Sea	30	29½	27½	10 (3)	-

(1) Current levels
(2) Manufacturing earnings only
(3) Brent price for delivery in July, as of 3rd July

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