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cc Mr Turnbull
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Strategy File

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TREASURY ECONOMIC FORECAST

JUNE 1984 REPORT

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TREASURY ECONOMIC FORECAST: JUNE 1984 REPORT

Introduction

This is the report on the (internal) June exercise. Detailed reports are (or very soon will be) available as follows:

World economic prospects, Mr Bottrill (EF2);

Public finances, Miss Peirson (PSF);

Oil production and revenues, Mr Hacche (MP2);

Financial forecast, Mr Mowl (EA2).

2. The budget forecast was completed in the first half of March. Data becoming available since then have been mostly consistent with our earlier forecasts of inflation, output, borrowing, and monetary growth. Differences include higher US interest rates, slightly higher UK rates, and a lower exchange rate. The miners' strike is reducing production now, but there should be some catching up later on.

3. For the world economy we expect, like most forecasters, continued but slower growth in the US (perhaps a recession by 1986) and continued but faster growth in most other countries. We have not allowed for major upheavals in the debt or banking worlds: our forecast looks consistent with these problems slowly getting better, in aggregate. A world of high interest rates and large debts (many of poor quality) has, however, considerable deflationary potential.

SUMMARY OF FORECAST

4. The next 10 pages summarise the forecast in words and numbers. More detailed sections begin on page 12. A table on pages 9-11 summarises our latest assessment of the UK, alongside the budget forecast. An annex to this forecast provides comparisons with earlier Treasury forecasts and with outside forecasters.

The fiscal prospect

5. The fiscal prospect is set out in some detail in a separate report. Our forecasts of the PSBR and fiscal adjustment compare with the budget forecast as follows:

PSBR

(fiscal adjustment in brackets)

£ billion

	1983-84	1984-85	1985-86	1986-87
Budget forecast/MTFS	10	7¼	7 (2)	7 (4½)
June forecast	10	6¼	7 (1)	7 (3)

The fiscal adjustments, expressed in annual not cumulative terms, are lower than in the MTFS because public expenditure is higher.

6. The FSBR quoted an average error of £4½ billion (based on experience of the 1967-83 period) for the PSBR in 1984-85. Errors in more recent years have typically been smaller, equivalent to some £3 billion. The improvement in forecasts between budget time and June is not always large (about 20 per cent on average) though in 1983 the June forecast correctly identified a substantial error in the 1983 budget forecast. Thus the downward revision of £1 billion to the PSBR estimate for 1984-85 and the worsening of the fiscal adjustments in later years are not necessarily of much significance.

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7. The main changes to the PSBR forecast in 1984-85 since the budget are as follows:

i) The forecast of oil revenues has increased by £$1\frac{3}{4}$ billion, reflecting both higher production and sterling prices (both already beginning to be evident in the data).

ii) Higher asset sales (£$\frac{1}{2}$ billion).

iii) Higher EC contributions (£$\frac{1}{2}$ billion), as a result of a more cautious assumption on refunds.

iv) Higher local authority spending (£$\frac{1}{4}$ billion).

v) Costs of miners' dispute (possibly £$\frac{1}{2}$ billion or so).

8. For 1985-86 and later the forecast suggests a slight worsening of the fiscal prospect despite the lower PSBR forecast for this year, mainly because

i) The underlying rise in central government expenditure - offset in 1984-85 only by higher receipts from asset sales - continues.

(ii) Higher debt interest payments next year as the effects of higher interest rates are felt.

(iii) A less marked rise in non-North Sea tax receipts (compared to the budget) in 1985-86 and later, particularly company taxes (reflecting lower profits) and local authority rates.

9. The relationship between expenditure forecasts, the plans in the PEWP (as amended in the budget) and departments' bids in the current survey are explored in the report on public finances. In broad terms, the forecast shows higher public expenditure than in the plans, particularly for later years: the pressures for increases are evident in areas such as local authority spending, nationalised industries, EC contributions, central government cash limits. An important reason for higher than planned spending, particularly in the later years, in the forecast is the assumed growth in public service earnings at 6-7 per cent in 1985-86 and 1986-87, about $\frac{1}{2}$ per cent a year less than in the private sector. There is considerable uncertainty about nationalised industries' EFLs: it is hard to judge prospective pressures partly because of the complications of privatisation.

10. Comparisons between the budget plans and the June forecast are given in the table below:

Planning Totals

cash, £ billion

	1984-85	1985-86	1986-87
PEWP (adjusted for NIS etc)	126.3	131.7	136.2
June forecast	126.7	133.1	139.4

cost terms, £ billion, 1982-83 prices

	1983-84	1984-85	1985-86	1986-87
PEWP/MTFS	114.1	114.2	114.3	113.7
June forecast	114.4	115.7	115.9	115.8

11. The higher cash figures in the June forecast imply that the new Reserve may be overspent in each year especially in 1985-86 and 1986-87. This is after a cash limit squeeze on volumes, equivalent to £0.3 billion in 1985-86, designed to offset in part the effects of higher pay in this forecast. The profile of public spending in cost terms remains fairly flat: with a growing economy and tax revenues rising there is still increasing scope for tax cuts - at least on the public expenditure and PSBR assumptions used in this forecast. The GDP deflators used to derive the planning total figures in cost terms are now showing slightly smaller increases in 1983-84 and 1984-85 and slightly larger increases in 1985-86 and beyond.

Financial forecast

Unless US rates rise more than we have assumed, we think that UK interest rates may not need to rise much or at all from current levels. But the level of rates in this forecast is about a point higher than in the FSBR forecast, reflecting higher US rates and a lower value of sterling. On the basis of current interest rate levels being broadly maintained for the next year or so (though the mortgage rate is liable to rise soon) growth of £M3 and M0 should stay within their target ranges. Other aggregates, PSL2, M2 and M1 may rise by 10 per cent or so in the current target period. Our judgment is that with real interest rates still high, monetary growth having come down and the exchange rate fairly steady, monetary conditions in the UK are compatible with a very modest fall in inflation over the next year. A slow fall in UK interest rates from mid 1985, especially if the dollar weakens as envisaged, should be consistent with meeting the monetary guidelines.

Inflation and the labour market

The rise in producer output prices, now around $5\frac{1}{2}$ per cent for the index excluding food, drink and tobacco, may slow to 4-5 per cent per cent in the course of 1985, influenced in particular by a steadying of the exchange rate and low inflation in other countries. The RPI inflation rate should soon fall to $4\frac{1}{2}$ per cent, the timing dependent on the vagaries of seasonal food prices (notably potatoes), and this remains our forecast for 1984 Q4. But the rate may edge up for a time in 1985, above the mid-year FSBR figure of 4 per cent.

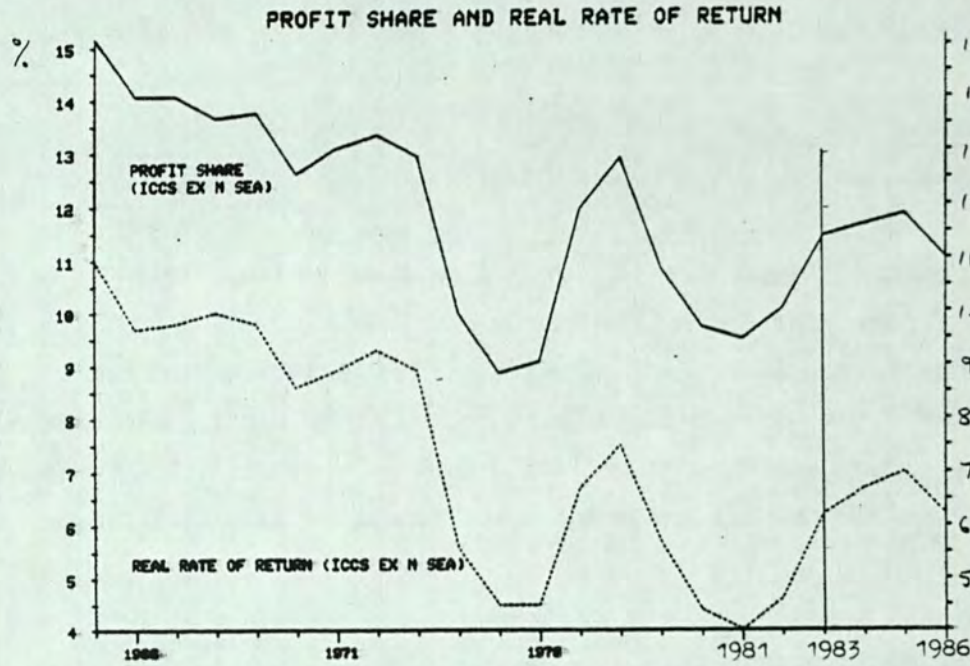
14. In the labour market, real wages are continuing to rise strongly: the rise has been stronger than expected at the time settlements were made because of unwarranted pessimism over inflation and the achievement of higher rates of productivity growth. But even at present levels of unemployment, pressures to reduce significantly the growth of real wages, and promote the growth of employment, seem to be very weak - much weaker than in the 1930s when from 1933-37 real wages changed little while employment rose by some 3-4 per cent a year.

15. This need not prevent inflation coming down further: but as over the past four years the labour market may play a passive role in transmitting lower price inflation into lower wage inflation, rather than an active role in bringing about lower unemployment.

Company sector

16. It is striking that despite the growth in real wages over the past few years, and the faster than expected slowdown in inflation, company profitability and finance have made a major turnround. Helped, particularly in manufacturing, by large productivity gains, the profit share of industrial and commercial companies (excluding the more profitable North Sea operations) is now close to its previous cyclical peaks; and the rate of return (which takes account in addition of the growth in capital employed) is near to 1978 levels:

PROFIT SHARE AND REAL RATE OF RETURN



17. With this turnround in company finance has gone - so far at least - a cautious attitude by most companies. This is expressed in a reluctance by manufacturers to increase employment (increased overtime being preferred); a desire to keep stocks down (so that we see no sign of the usual stock cycle); a low level of investment (despite the sizeable increases signalled by the DTI intentions enquiry); and a high level of liquidity.

18. Some reluctance to spend is understandable given the experience of 1980-81, and the increased returns on financial assets from high real rates of interest. But the potential exists for a sharp increase in spending by companies: we have made some allowance in this forecast and perhaps more than most outside forecasters.

19. Reluctance to borrow and spend has not been characteristic of consumers. Their real incomes are now rising strongly and continue to do so in this forecast as tax cuts add to rising real wages and employment. Consumers should be able to sustain spending increases of some 3 per cent a year in real terms while maintaining their stocks of wealth and a saving ratio of 9 per cent or so.

Money demand and output

20. The external forecasts and the assumptions of a very slow fall in the (planned) PSBR and in the growth rate of the main monetary aggregates points to a continuing slow decline in the growth of money GDP:

	r983-84	1984-85	1985-86
PSBR, percentage of GDP	3¼	2	2
Growth rates:			
£M3)	9½	8	7
) target periods			
MO)	6	6	4½
Money GDP	8	7½	7½

20. Growth of nominal income is generally more stable than that of the monetary aggregates, and consequently somewhat less difficult to forecast. The split of money GDP between quantity and price might be as follows:

growth rates, per cent

	1983-84	1984-85	1985-86
Output	2½	3	3
Prices	5	4½	4½

21. Consistently with the recent rapid increase in profitability, the recovery continues through 1984 and 1985, perhaps tailing off in 1986 with a near-recession in the US and a slowing down in the investment cycle in the UK.

22. We stick to the 3 per cent growth rate for output in 1984: another upward revision to oil production (worth ¼-½ per cent on GDP) broadly offsets the lost output due to the miners' dispute, assumed to end in the summer.

per cent changes on a year earlier

	1983	1984	1985
Domestic demand	4½	3	2½
of which consumer spending	4	2½	3
Exports	1	6	4
Total output, GDP	3	3	3
GDP less oil	2½	3	2½

23. The rise in employment since early 1983 was accompanied by a further rise in unemployment, as many of the new jobs were filled by people not on the register. We do not expect much change in unemployment over the next year or two, on the assumption of a more normal relationship between employment and unemployment.

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SUMMARY TABLE AND COMPARISON OF FORECASTS

	FSBR/MTFS MARCH 1984	JUNE 1984
PSBR and Fiscal Adjustment (annual not cumulative) (£ billion)		
1983-84	10	9.7
1984-85	7¼	6¼
1985-86	7(2)	7(1)
1986-87	7(4½)	7(3)
Interest Rates Short-term per cent		
1983-84	9½	9½
1984-85	8½	9½
1985-86	8	9
1986-87	7	8
Money Supply £M3 (% change on year earlier)		
1983-84 target period	9	9½
1984-85 " "	9	8
1985-86 " "	8	7
1986-87 " "	8	6½
Money Supply £M0 (% change on year earlier)		
1983-84 target period	6	6
1984-85 " "	6	6
1985-86 " "	5½	4½
1986-87 " "	5½	4½

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	FSBR/MTFS MARCH 1984	JUNE 1984
World Trade in Manufactures		
(% change on year earlier)		
1983	1	0
1984	5	5½
1985	4½	5½
1986	~~4½~~	5
Effective Exchange Rate		
1975 = 100		
1983	83	83
1984	83	80
1985	83	81
1986	83	81
Current Balance		
(£ billion)		
1983	2	3
1984	2	1½
1985	½	2½
1986	1	0
RPI		
(% change on year earlier)		
1983 Q4	5	5
1984 Q4	4½	4½
1985 Q4	(4)	4½

	FSBR/MTFS MARCH 1984	JUNE 1984
Nominal GDP (mp)		
(% change on year earlier)		
1983	8½	8½
1984	8	7½
1985	7	7½
1986	6	6
GDP Volume		
(% change on year earlier)		
1983	3	3
1984	3	3
1985	2½	3
1986	2	1½
Manufacturing Output		
(% change on year earlier)		
1983	1½	2
1984	3½	3
1985	2	1½
1986	1½	1
Unemployment		
(UK sa excluding school leavers, millions)		
1984 Q1	3.0	3.0
1985 Q1	3.0	3.1
1986 Q1	3.0	3.1

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The World Economy

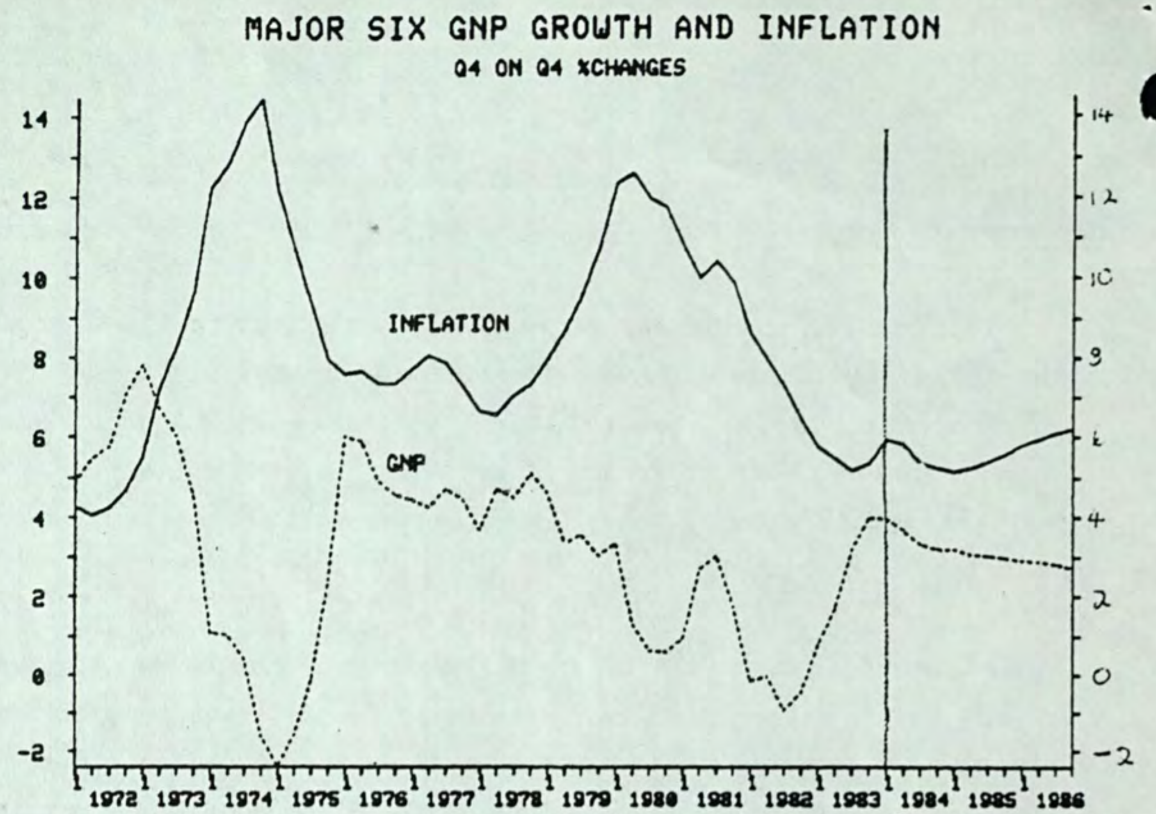
Activity has continued to recover with inflation low in most countries. Our forecast for the world economy has not changed very much since the budget, though US interest rates are distinctly higher and the worries about third world debt and US banking are greater. A full account is given in the report on the world economic prospects, circulated by Mr Bottrill.

We assume that in the US fiscal policy is gradually tightened: that the "down payment" is accompanied by further measures, of about the same size, to reduce the scale of the Federal deficit from some 5 per cent of GDP in 1984 to perhaps $3\frac{1}{2}$ per cent of GDP by 1988. Monetary policy in the US, assumed to give some weight to both debt and banking problems, still produces high interest rates, a little above current levels, for the second half of 1984 and for 1985. Slowly, and with some hesitation, fiscal and monetary policies are assumed to come more into line, at a much higher debt/income ratio and with a somewhat higher rate of inflation. This policy stance, together with a much reduced growth rate of activity (reflecting partly restrictive monetary policy), should allow nominal, and still more real, interest rates to fall, from mid 1985. As a result of these expectations developing, the value of the dollar is liable to fall, perhaps sharply.

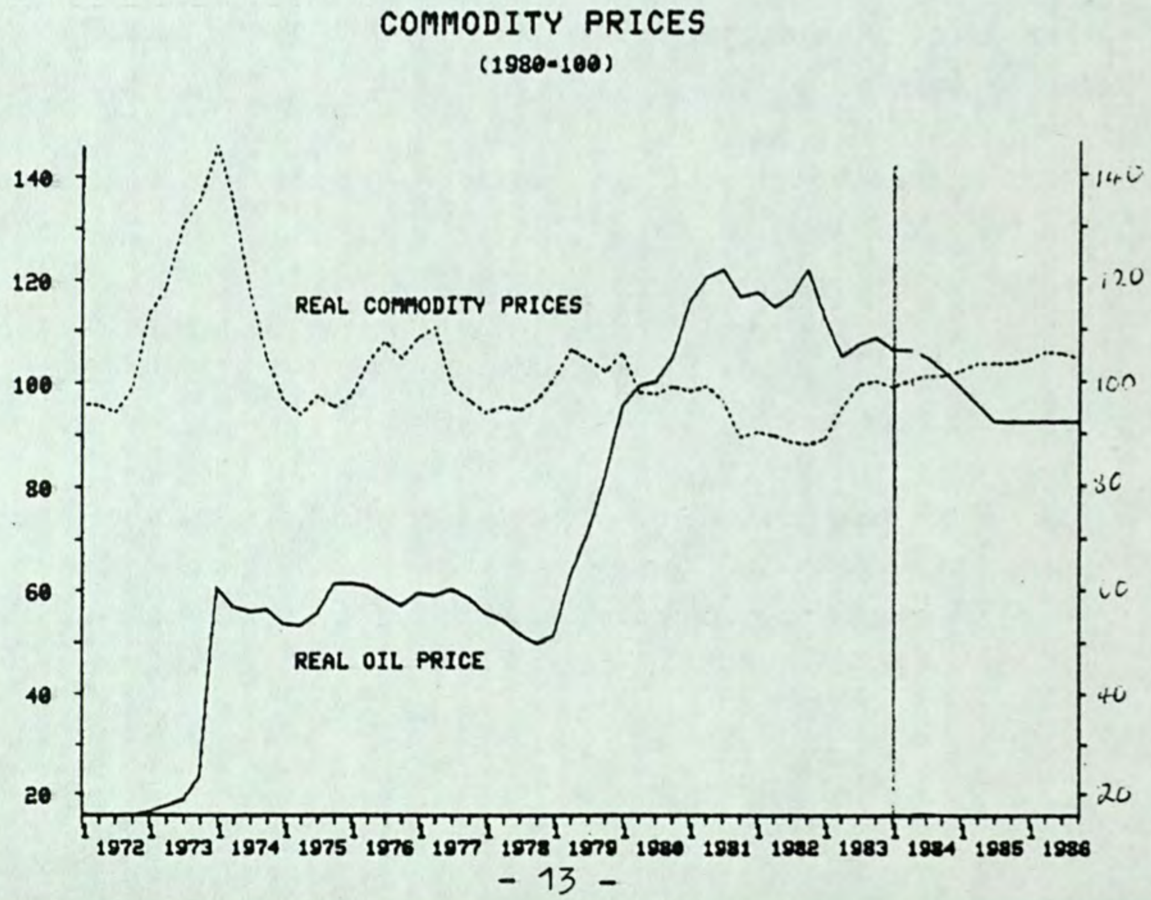
The forecast for output, inflation and trade is summarised in the following table and chart:

per cent changes (Budget forecast in brackets)

	1983	1984	1985	1986
Major 6 output	$2\frac{1}{2}$	5 (4)	3	$2\frac{1}{2}$
Major 6 consumer prices	$4\frac{1}{2}$	$5(4\frac{1}{2})$	5	$4\frac{1}{2}$
World trade in manufactures (UK weights)	0	$5\frac{1}{2}(5)$	$5\frac{1}{2}$	5



Commodity prices show the usual diverse patterns. Oil prices have not reacted much to the intensification of the Iraq/Iran war and we continue to expect (further) falls in real terms, with a constant dollar oil price while the dollar is forecast to fall back , starting in 1985, from current high levels. Food prices (especially cereals, tea, cocoa) are now high and may come back, though the effect on the UK is muted. Industrial materials' prices may show some increases in real terms as a result of the growth in world industrial demand. The chart below provides a summary:



In this forecast - as in previous ones - the problems of third world debt gradually diminish as a result of:

i) rapid growth in export volumes and no significant worsening in their terms of trade;
ii) a lower value of the dollar and, after 1985, lower dollar interest rates;
iii) resumed moderate flows of private capital;
iv) continued adjustment policies to restrain imports.

In consequence, various measures of the debt problem some show improvement: the real stock of debt falls, the ratio of debt service to export earnings falls etc. None of these highly aggregate measures, even if correctly forecast, can throw much light on whether the debt problems of particular countries can be overcome. A summary of world import growth, by volume, is shown in the table below:

	Share of UK exports in 1983	1973-1979 average	1983	1984	1985
US	14	7	10	24	6
Other industrialised countries	65	$3\frac{1}{2}$	2	6	7
OPEC	10	$14\frac{1}{2}$	-11	-2	3
Non-oil developing countries	11	$6\frac{1}{2}$	-2	6	9
Total*	100	$4\frac{1}{2}$	$1\frac{1}{2}$	$7\frac{1}{2}$	7

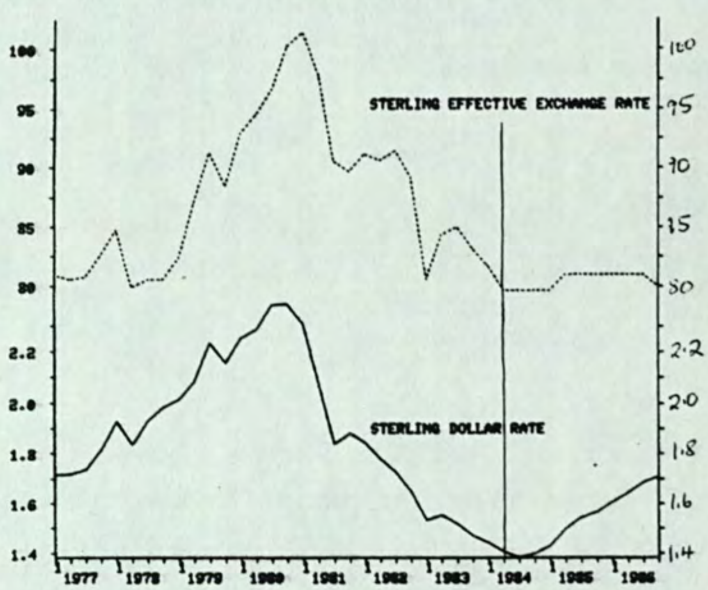
*For 1984 and 1985 the forecast growth of total world imports is faster than that shown in the table on page 12, mainly because the UK has a higher weight in some slow growing markets, notably OPEC.

The exchange rate

Over the past year and more, sterling has fallen against the dollar and risen against most European currencies. For some time we have been expecting this pattern to be reversed, but the dollar has remained high. We still expect the dollar to fall - starting perhaps in 1985 rather than this year - once the markets see a prospect of US interest rates levelling out and then falling.

Our projection of no major change in the UK effective rate, at about 80, takes account of forward rates, of the path of oil prices (forecast to be constant in depreciating dollar terms well into 1985) and the continuing surplus on the current account, together with the pattern of interest rates. The forecast fall in oil production after 1985, perhaps accompanied by a move into deficit of the current account, may not yet be fully discounted by the market, and could induce some weakness in sterling. The expected weakness of the dollar could strengthen sterling a little, but by less than the yen and the mark.

STERLING EFFECTIVE EXCHANGE RATE AND DOLLAR RATE



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Trade and the balance of payments

The large current account surpluses in 1980-82, when the UK recession was deeper than the rest of the world, were succeeded by a moderate surplus in 1983. Overall, the current account is expected to remain in surplus for a time, though with substantial shifts in its composition.

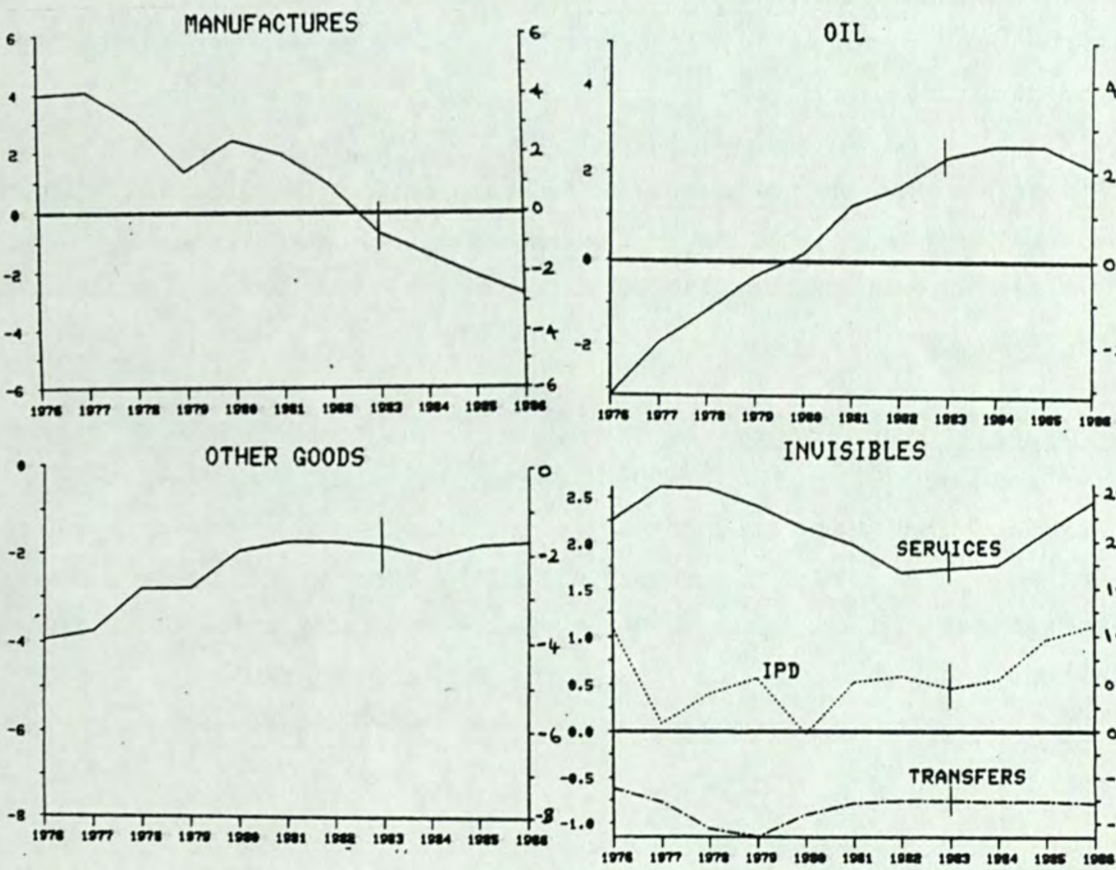
These surpluses have contributed, along with asset and currency revaluations, to a sharp rise in the value of the UK's net holdings of foreign assets:

	£ billion	per cent of GDP
end 1979	15	$7\frac{1}{2}$
end 1983 (estimate)	56	18
end 1985 (forecast)	75	21

The changing composition of the current account is shown in the chart and table below:

Balances as per cent of GDP

(not on same scale)



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Surpluses and deficits, £ billion

	(per cent of total goods)	1983	1984	1985	1986
Oil	(17)	7	8½	9	7½
Manufactures	(66)	-2	-4½	-7	-10
Other goods	(17)	-5½	-6½	-6	-6
Total goods	(100)	-½	-2½	-4	-8½
Total invisibles		3½	4	6½	8½
Current balance		3	1½	2½	0

The prospects for oil are described in detail in a separate note by Mr Hacche. The slightly higher figure for the oil balance in 1984, compared to that underlying the FSBR forecast, takes account of higher production and prices, partly offset by the extra oilburn resulting from the miners' strike.

The balance on manufactures turned into deficit in 1983, and with import volumes continuing to grow faster than exports, and little change in the terms of trade, we expect the deficit to increase over the forecast period, though less strongly than in 1983.

Exports of manufactures in the three months to April were 9 per cent up by volume on a year earlier, reflecting both the sharp recovery in world markets and what looks like an erratically low level of exports for much of 1983. Over the forecast period, with little contribution from changes in competitiveness, we expect to see a slowly declining share of UK exports in both volume and value terms, in line with long-term trends:

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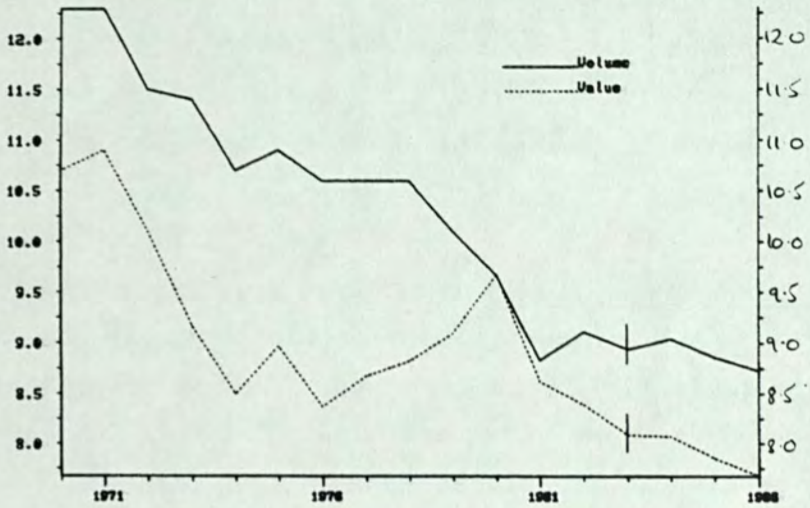
Exports : Share of World Trade in Manufactures



As in other industrialised countries, import penetration in manufacturing in the UK has been on a rising trend for a number of years, as some barriers to trade have fallen and international specialisation has increased (with world trade generally growing faster than industrial production). In addition, domestic demand for manufactures grew strongly in 1983 (probably at a faster rate than at any time since 1973), leading to a pick up in manufacturing import volumes, despite some improvement in price competitiveness:

Per cent changes on a year earlier

	Domestic Demand	Import Price Competitiveness*	Imports of Manufactures (excluding erratics)	Domestic production
1981	-5	11	4½	-6½
1982	1	2½	10	0
1983	7	- 2	11	2
1984	4½	- 3½	11	3
1985	3½	- 3	6½	1½
1986	3½	- 1	6½	1

*lagged one year. Increase represents worse competiteness.

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While imports of manufactures volumes are growing strongly at present (in the three months to April they were up 14 per cent on a year earlier) we expect the slowdown in the growth of domestic demand for manufactures, coupled with recent improvements in price competitiveness, to lead to a slowdown in manufacturing import volumes after this year.

The outlook for trade prices is particularly important for the balance of payments, domestic inflation and profitability. As sterling has fallen from its peak in early 1981, both export and import prices have been rising faster than domestic prices. This has helped to restore export profit margins to more normal levels (although they remain some way below their 1977 peak) and has raised import prices relative to those for domestically produced goods. In our judgment, this recovery is now substantially complete, at least for manufacturing, provided that current levels of the effective exchange rate are maintained, and domestic costs grow more in line with our competitors.

Perhaps one of the surprising features of our trading patterns in recent years has been the stability of our terms of trade: between 1980 and mid 1983, these remained virtually unchanged, despite a fall of 12 per cent in the effective exchange rate. There were a number of reasons for this:

(i) World commodity prices (excluding oil) fell in real terms in 1981 and 1982.

(ii) The pattern of exchange rate movements was on balance favourable to the UK: in particular, while the fall of sterling against the dollar and the yen helped export volumes, its strength against the continental currencies kept import prices in check - though the strong dollar probably helped to sustain real oil prices.

(iii) As usual when the exchange rate falls, importers were willing to reduce their profit margins, and exporters to increase them. Moreover in the case of basic materials, importers seem to have had abnormally high margins in 1980, which allowed them to keep import prices virtually unchanged in 1981 and 1982.

Some of these factors have now started to unwind: world commodity prices (excluding oil) have tended to increase in real terms as world industrial production picks up, and recent exchange rate movements have led to some acceleration in import prices. As a result the terms of trade have declined by 3 per cent since their peak in the third quarter of 1983. Nonetheless the slower growth from now on in import prices, as the exchange rate is assumed to stabilise, is an important influence on the path of domestic inflation. Weakness in the real oil price through 1985 is also a help. In total, import prices (including oil) are forecast to rise 4-5 per cent a year from now on, compared with 7-8 per cent in 1983 and 1984 (first half).

The invisibles balance in 1983 was running at a lower level, in relation to GDP, than for most of the 1970s. In part this reflects the build up of IPD debits on oil (a partial offset to the gains on oil in the trade statistics), but it also reflects the influence of a strong pound and sizeable competitiveness effects on services, and the continuing decline in the UK merchant fleet. The growth of overseas assets has shown up only weakly in higher IPD earnings, implying a low return on assets; this may be partly a problem of inadequate statistics (revisions to IPD data tend to be upward) as well as a tendency to invest in assets with a low current return. We expect strong growth in both services and IPD earnings over the next few years, with the recent changes in competitiveness contributing to the strong rise and in service volumes. The balance on transfers is not expected to change much over the forecast period, although the more cautious assumptions now being made on EC transfers have lowered the balance for 1984 by over £300 million.

Overall, the growing deficit on manufactures and the falling surplus on oil may offset the rise in invisibles and the smaller deficit on other goods. By 1986 this could result in the current account moving towards and perhaps into deficit.

Demand and activity

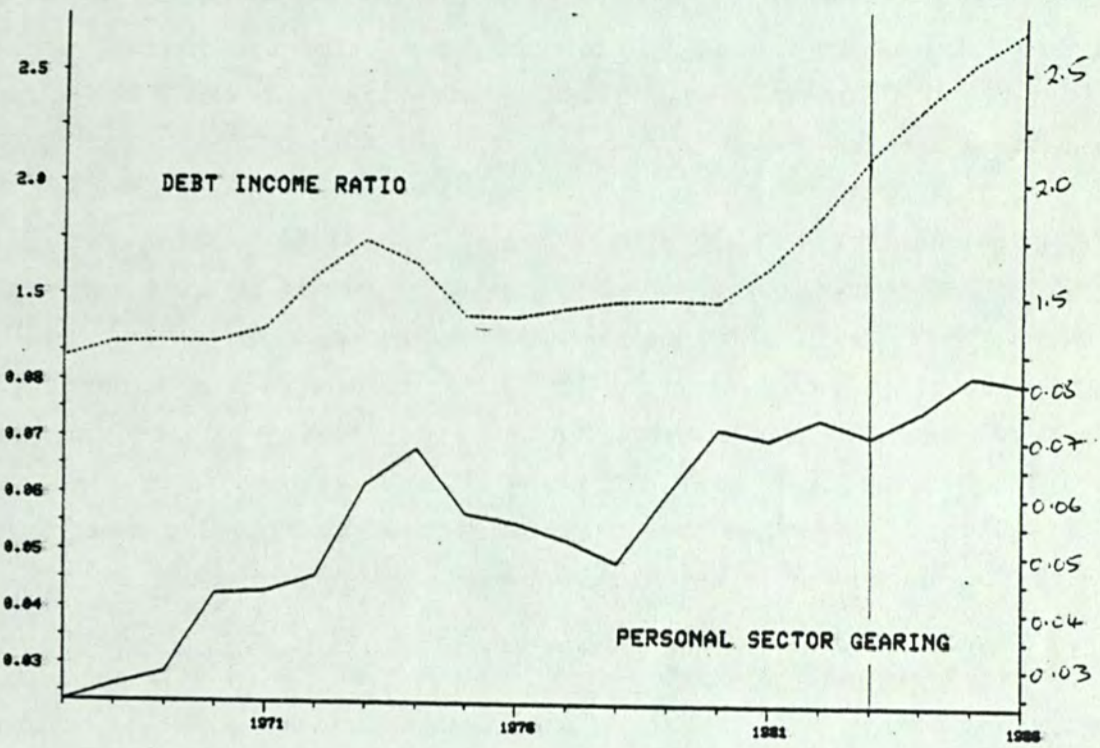
Personal sector expenditure has grown strongly over the past two years: initially there was a reduction in saving; only over the past year have real incomes risen strongly.

The reductions in the saving ratio and increased expenditure on housing have been more than financed by substantial increases in consumer borrowing. As banks have moved into the housing market, and building societies have adjusted to increased competition, personal sector indebtedness has far outstripped the growth in disposable incomes:

	Banks and building society lending (net increase, £ billion)	Percentage change in stock of bank and building society lending	Percentage change in personal disposable income
1981	13	25	$8\frac{1}{2}$
1982	18	32	8
1983	$19\frac{1}{2}$	26	7
1984 (forecast)	$21\frac{1}{2}$	19	8

Some of this borrowing has offset other forms of credit. Part has helped to build up stocks of financial assets - perhaps because the liberalisation of the financial system has encouraged borrowers to move to cheaper sources of finance and has allowed households to correct previously distorted portfolios. But the ratio of personal sector debt to income has now risen so far above past experience - mostly periods of control over lending - that we have little to guide us on the potential limits. Lower interest rates have nevertheless helped bring down the costs of servicing the debt, so that (the uncertainly measured) personal sector gearing ratio looks less exceptional:

PERSONAL SECTOR INCOME GEARING



The area most obviously associated with this expansion of credit has been expenditure on consumer durables (particularly cars and white and electrical goods). Typically, strong cycles in durables occur during periods of fast increases in real disposable income and when credit conditions ease. This time, the expansion started when real incomes were basically flat and when nominal interest rates were falling, though real interest rates remained high. The conventional allowances for the effects of removing HP controls are much too small to explain the size of the boost to expenditure; and it seems unlikely that the effect on real balances of falling inflation rates or revaluations would, in themselves, have been large enough. It looks as though a mixture of improved confidence, a depleted stock of durables, large relative price changes and perhaps distributional effects (substantial after-tax rises in real income amongst those in work) have generated a strong cycle. The process has been made possible by the lifting of constraints on the financial system, so that the banks have had incentives to supply credit to those previously unable to raise their stocks of physical assets to desired levels.

For the forecast, the main issue is whether a period of rising real personal disposable income accompanied (perhaps by late 1985) by falling interest rates will serve to extend the durable boom beyond normal lengths. While some of the current signs are adverse (the fall in expenditure in the first quarter, the assessments by the car industry of little or no growth in sales volume this year and reports of a falling-off in some electrical goods sectors) we stick to our assessment of continued underlying growth, though at much slower rates than over the last two years.

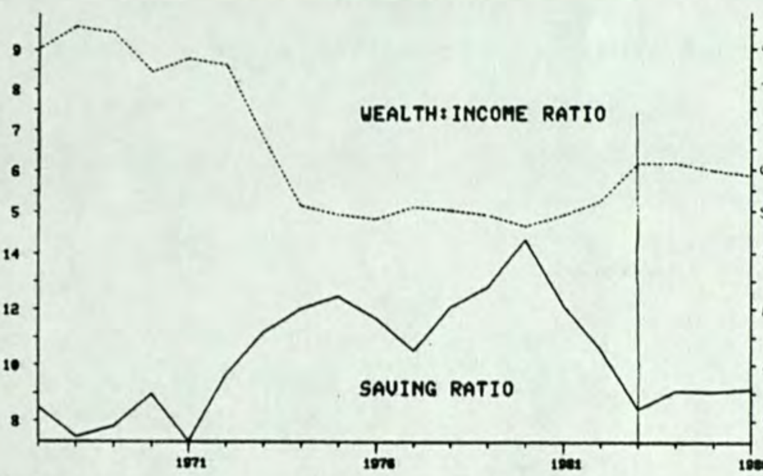
Consumer spending on non-durables has been rising at 2 per cent a year, partly reflecting the effects of inflation on the saving ratio. Future gains from this direction will be smaller and non-durable expenditure is expected largely to follow the path of real disposable income.

Percentage changes

	Volume of Consumer Expenditure		Real personal disposable income	of which due to fiscal adjustment
	Durables	Non-durables		
(Weight in 1980)	(10)	(90)		
1982	8	½	-½	
1983	16½	2½	1½	
1984	3	2	3	
1985	5	3	3	0
1986	1	3	3	1½

Rising equity and bond prices, a lower rate of inflation and modest rates of investment have led the personal sector to rebuild its stock of financial wealth in recent years despite declining saving ratios. Little further change is expected in the forecast period. With large increases in mortgage lending and lower interest rates the recovery in the private housing market, in terms of investment or prices, has not been exceptional. We expect a fairly modest recovery to continue.

SAVING RATIO AND WEALTH:INCOME RATIO

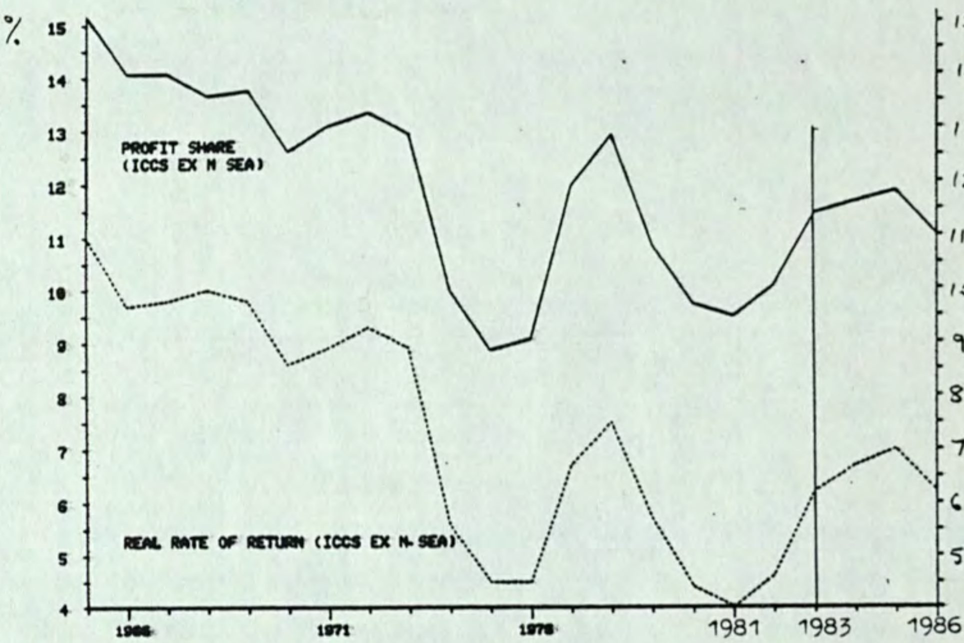


The process of adjustment to lower rates of inflation and smaller public sector deficits involved considerable changes in company sector behaviour between 1979 and 1981-82. Particularly in manufacturing, **profit** margins were cut substantially, employment was reduced and expenditure on stocks and investment curtailed. The last year has seen a major recovery in profitability and an upturn in manufacturing investment. Employment has turned around - at least outside manufacturing - and the period of destocking seems to be over, even if there is little sign of much rebuilding of stock levels.

On most measures, the company sector now seems to be in a comfortable position in historical terms. Real rates of return for the whole non-North Sea industrial and commercial sector are estimated to be back at their 1978-79 levels, consistent with the substantial recovery in the share of profits in GDP. The sector ran an enormous financial surplus in 1983, with borrowing needs that seem currently fairly modest. And their liquidity is virtually at record levels.

Rate of Return and Profit Share

(Industrial and Commercial Companies less North Sea)

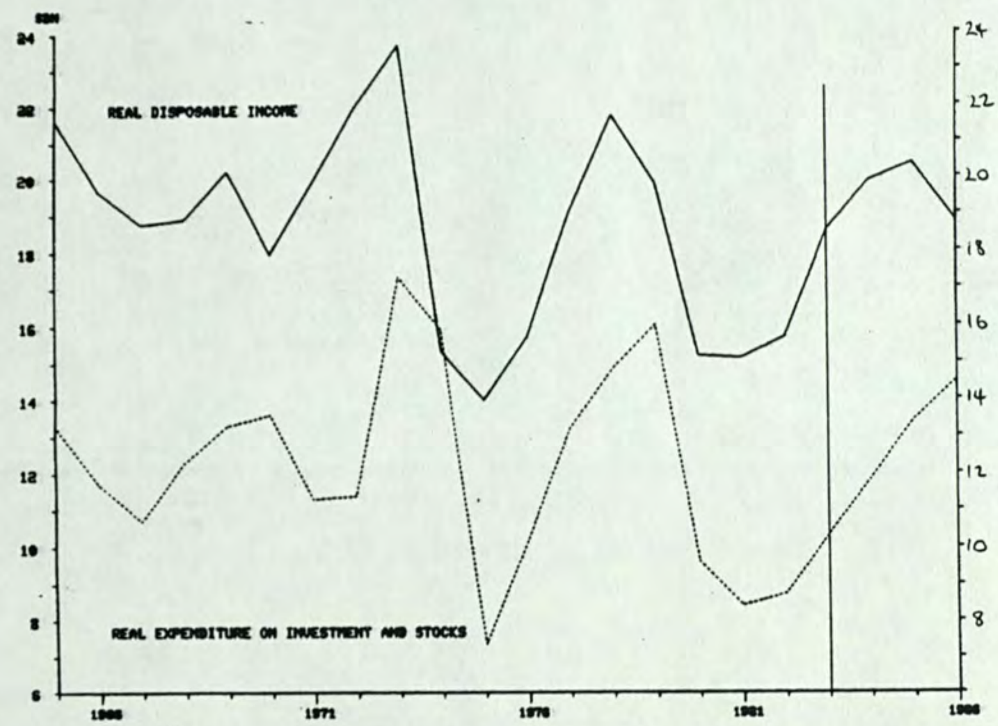


But the data in this sector are notoriously unreliable: figures for financial transactions indicate a much less buoyant (though still good) situation compared with National Accounts data. Higher nominal rates of interest and lower effective margins being charged by banks also provide incentives for companies to build up their stocks of (gross) liquid assets, aided by the increased dependence this cycle on leasing activity.

For these reasons, the forecast takes a relatively cautious view on the possible implications for spending of ICC's current financial position. There are undoubtedly incentives for higher investment in the form of improved returns. But companies seem to hold fairly modest expectations about the sustainability of current rates of output growth. And it may be that we are seeing, in manufacturers' reluctance to take on new labour or to allow their stock levels to rise, a determination not to return to the financially exposed positions of the early and late 1970s. With higher profitability they are of course more vulnerable to upward pressure on wages - but, again, improved liquidity increases their capacity to withstand industrial disputes. The forecast foresees a maintenance of recent higher levels of real disposable income but expenditure, responding with a lag, not rising quite as fast as in previous cycles.

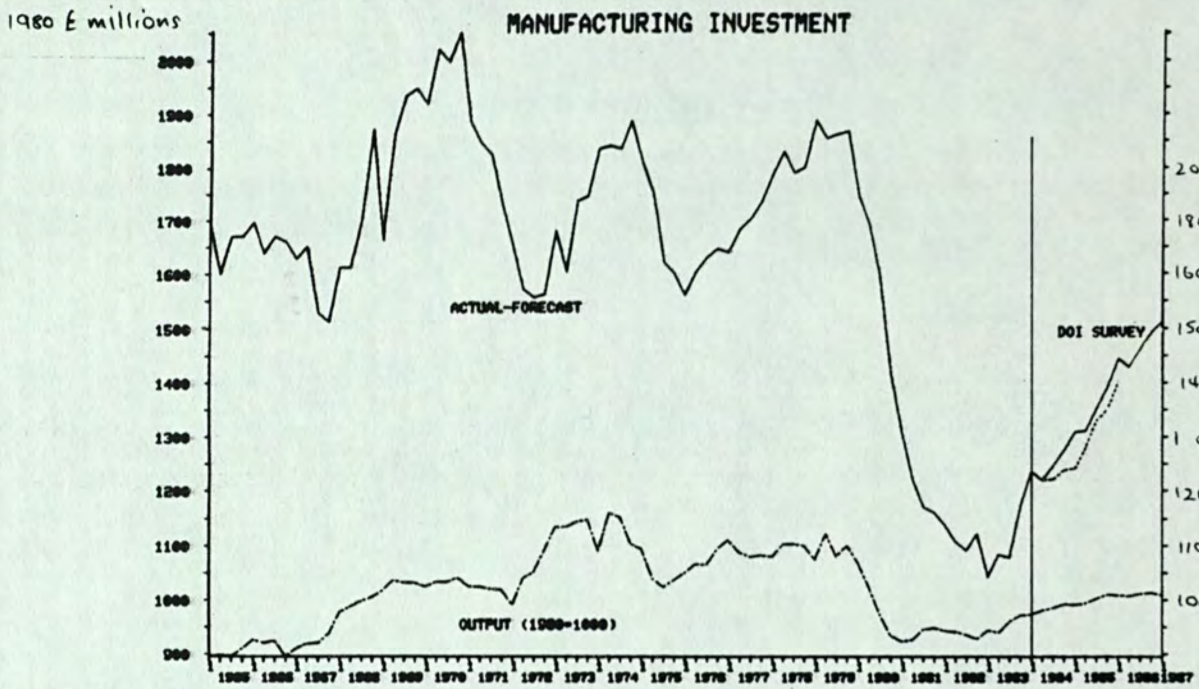
Income and Expenditure

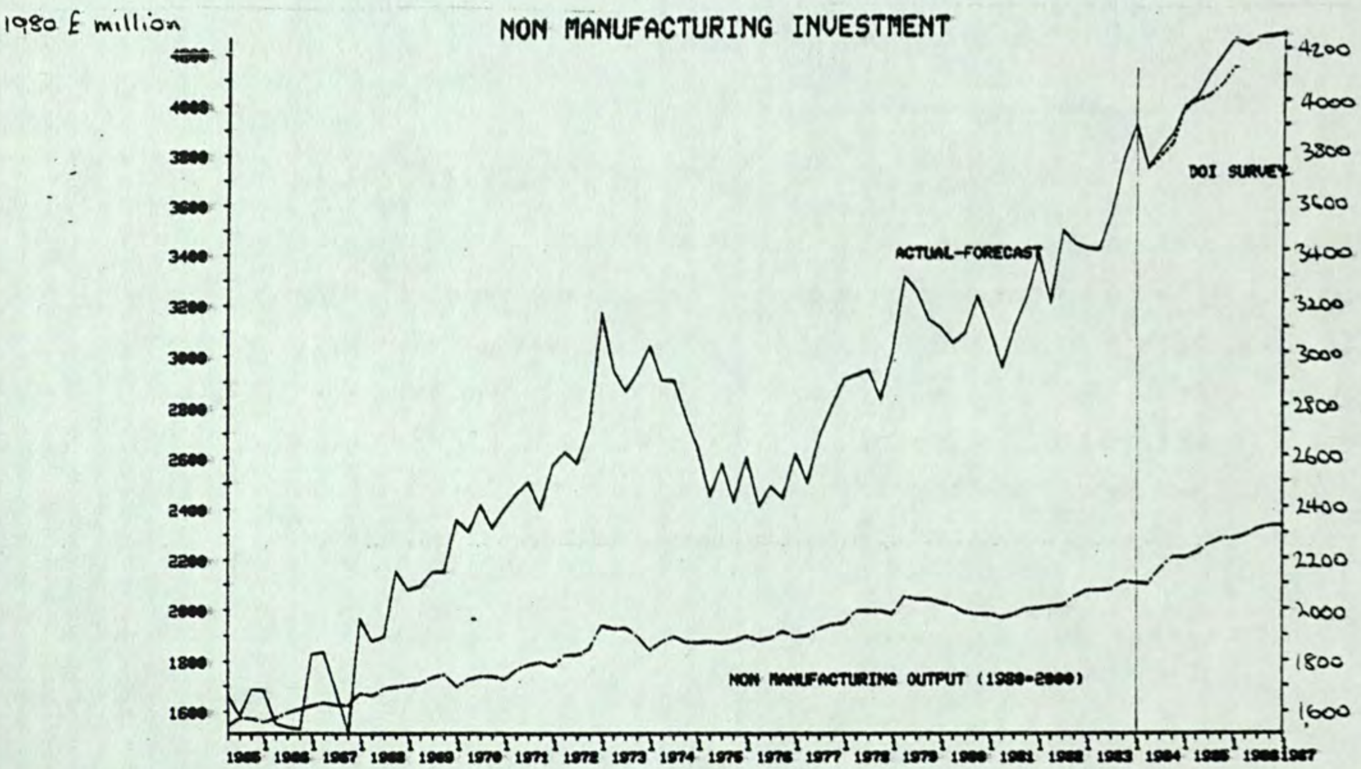
(Industrial and Commercial Companies less North Sea)



The difference between the income and expenditure lines above reflects dividend distributions and financial surplus. Further growth in dividends seems likely in 1984 and 1985. Abstracting from recent setbacks it is likely that the underlying state of the stock market, accompanied by better profitability of firms and increased takeover and merger activity, will provide additional incentive for companies to distribute earnings.

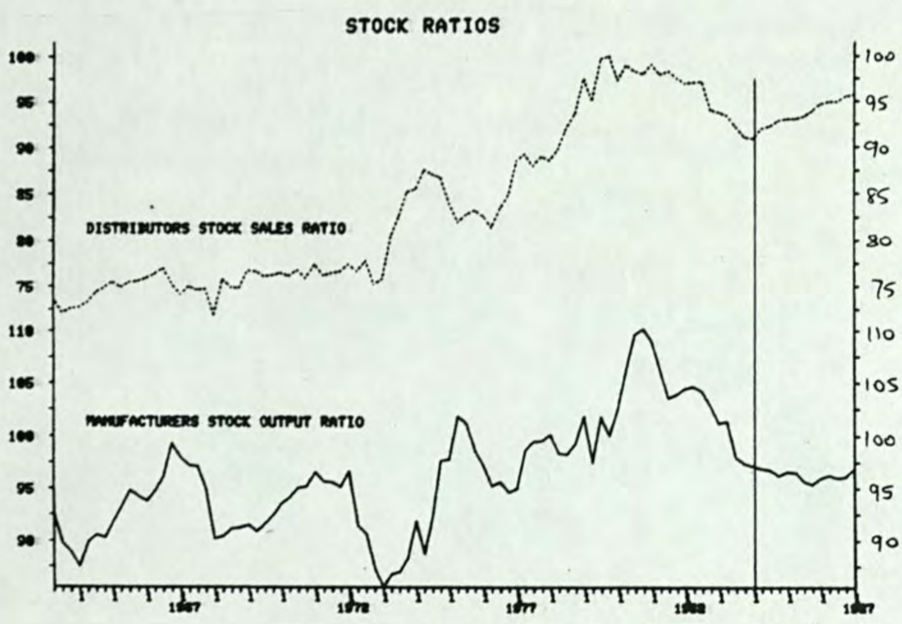
All recent surveys point to a substantial rise in business fixed investmnent this year. Even before the incentives provided by the corporate tax changes in the budget to bring forward expenditure into the current financial year, the prospects were for a marked recovery in the manufacturing sector as output and profitability improved. Including an allowance for the effects of the budget, the increase is now put at about 14 per cent, continuing at a rate of growth of about 7 per cent into 1985. This is not, however, exceptional by historical standards and will leave the level of investment fairly low in both absolute terms and relative to manufacturing output.





Outside manufacturing, the recession seems to have had little impact on total investment, bolstered by a very strong performance in some sectors, notably financial property, retail trade and the rental industry. Further strong growth is expected in the retail sector this year. With improvements also likely in construction and road transport and with the advent of cable, investment is likely to continue increasing at 5-10 per cent per year.

Despite new computerised techniques and the high nominal costs of borrowing, stock-output ratios rose steadily through the 1970s - perhaps because of increased uncertainty about the availability and price of supplies, the impact of the stock-relief scheme and the lower real cost of holding stocks. But the evidence so far is that this process may now be in reverse. It is difficult to separate out underlying from cyclical influences, but recent behaviour and surveys suggest a strong desire not to allow stock-output ratios to rise above current levels. The budget changes and the high real return available on financial assets will reinforce this. Only outside manufacturing, where stocks of consumer goods may have been brought below desired levels by the strength of expenditure on durables, are we expecting to see any significant rebuilding of stocks.



Demand and activity summary)

The prospects for domestic demand (at constant prices) are summarised in the table below:

	per cent changes on a year earlier			
	1983	1984	1985	1986
Personal consumption	4	$2\frac{1}{2}$	3	$2\frac{1}{2}$
Public consumption	2	$1\frac{1}{2}$	$\frac{1}{2}$	0
Public investment*	7	-4	-3	0
Private investment*	4	11	4	4
Change in stockbuilding (as per cent of level of GDP)	1	0	0	0
Total domestic demand	$4\frac{1}{2}$	3	$2\frac{1}{2}$	2

The substantial growth in exports expected in 1984 and 1985 is forecast to offset the slowdown in the growth of domestic demand. By 1986 the fall forecast for oil production is reducing exports of oil by 10 per cent or so.

	1983	1984	1985	1986
Domestic demand	$4\frac{1}{2}$	3	$2\frac{1}{2}$	2
Exports of goods and services	1	6	4	1
Imports of goods and services	5	$7\frac{1}{2}$	$3\frac{1}{2}$	4
Domestic production: GDP	3	3	3	$1\frac{1}{2}$
Manufacturing	2	3	$1\frac{1}{2}$	1

*Excluding the effects of council house sales and privatisation.

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The **miners' strike action** began on March 12. About three-quarters of pits were idle in April, apparently representing a loss of nearly 70 per cent of the output of the coal and coke industry, itself normally about 4 per cent of industrial production. The effect on the level of industrial production in April was a reduction of $2\frac{3}{4}$-3 per cent. There has been a further loss in the electricity production industry where, although gross output is unaffected, net output is reduced because the oil being used as an input is of a higher price than the coal it replaces. This second loss is not yet apparent in the published industrial production figures but we estimate that making allowance for both this and the loss of coal output is likely to reduce GDP in the second quarter by about $1\frac{1}{4}$ per cent from levels it would otherwise have reached.

The table below gives an estimate of what the loss of GDP will be in 1984 assuming a partial recovery of lost output in the summer and autumn after the end of the strike. Stocks are gradually rebuilt later this year and during 1985 but that part of output which was replaced by an increase in imports is permanently lost. The net effect is to reduce the level of GDP in 1984 by $\frac{1}{2}$ per cent but to raise the growth rate by a little more than $\frac{1}{2}$ per cent in 1985 as some of the output loss is made good. Underlying growth continues to be steady during the course of 1984 although the forecast path including the strike effects is more erratic.

Effects of the miners' dispute

£ billion (percentage changes in brackets)

	1984	1985	1986
Domestic production reflected in	- 1.1 (-0.5)	+ 0.3 (0.1)	+ 0.1
Stock change	- 0.4	+ 0.3	+ 0.1
Increased imports	- 0.7	0	0

The path of GDP, for the past, is measured by the average measure of GDP. (The output measure probably gives a better indication of changes between one quarter and the next, especially in the most recent periods).

The estimated effects of the miners' dispute and of North Sea oil and gas production on the total GDP can be seen in the following table:

1980 = 100, and per cent changes on a year earlier

	1982	1983	1984	1985	1986
GDP average measure	100.5 (2.0)	103.5 (3.0)	106.5 (2.9)	109.5 (2.9)	110.9 (1.3)
GDP <u>less</u> contribution of N Sea production	99.4 (1.3)	101.9 (2.6)	104.3 (2.3)	107.4 (3.0)	109.5 (1.9)
GDP <u>less</u> effects of miners' strike	100.5 (2.0)	103.6 (3.0)	107.1 (3.4)	109.4 (2.2)	110.9 (1.4)
GDP <u>less</u> contribution of both oil and miners' strike	99.4 (1.3)	102.0 (2.6)	104.8 (2.8)	107.3 (2.3)	109.4 (2.0)

The growth of oil production has accounted for half a per cent a year of the growth of GDP for the last four years but a forecast contraction in 1985 and 1986 is expected to reduce growth. It should, however, be recognised that future levels of oil production are particularly uncertain.

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Employment, labour force and unemployment

Total employment has been rising since early 1983. Evidence from the 1983 Labour Force Survey helps to confirm the size of the DE allowances for undercounting, reflected in the supplementary series for the employed labour force. By the first quarter of 1984 this was perhaps 250 thousand up on a year earlier.

Within this total, employment in manufacturing fell 120 thousand, or about 2 per cent. With output rising by 3 per cent, output per man rose $5\frac{1}{2}$ per cent. Average hours worked rose $1\frac{1}{2}$ per cent, and output per man hour rose 4 per cent. The rise in average hours reflects a substantial reduction in short-time working and an increase in overtime which has brought both overtime per operative and the proportion of operatives working overtime well above average levels. This suggests, as often happens at this stage of the cycle, a cautious policy on the part of firms: unsure about the duration of the recovery, they may see a future drop in overtime as an easier response to a falling off in orders than laying off more employees. But if, as we expect, the recovery is sustained then future increases in demand for labour should take the form of higher employment (compared to what it would otherwise be) rather than yet higher overtime. This is reflected in our forecast of growth in output per head which slows significantly through 1984 and 1985.

Our judgments on productivity growth are set out in the table below.

Manufacturing, per cent changes on a year earlier

	Output	Output per head	
	Average	Trend	Actual
1964-73	3.0		3.9
1973-79	-0.7		0.8
1979-81	-7.5		-0.2
1981-83	1.0	3.5	6.4
1984)		3.2	4.6
1985)	1.9	3.1	2.6
1986)		3.0	2.5

There is little doubt that the fast productivity growth in the period 1981-83 reflected, in part, cyclical recovery. But part also reflects, we think, a speeding up of the trend compared with the (very slow) seventies. This may have been partly due to more rapid adoption of new technology but it seems likely that there have also been permanent improvements in the utilisation of the labour force (less restrictive practices, less waiting time). Although financial pressures on companies, intense in 1980, have turned round almost completely, the large gap between UK and eg German productivity levels together with perhaps some shift in management attitudes suggest to us only a very modest easing in underlying productivity growth in manufacturing. Growth in real wages is forecast to continue quite strongly; there is little sign of the labour market delivering the substantial fall in real labour costs that would be required to produce an appreciably better employment picture.

Outside manufacturing, where there is little evidence of unusual productivity growth this cycle, the employment forecast is dominated by the growth in output which, forecast at 3 per cent average for 1983-86, looks to be comfortably ahead of the rise in productivity. All this suggests that total employment in the economy may rise by some 150 thousand ($\frac{1}{2}$-$\frac{3}{4}$ per cent) a year over this period.

Since early 1983 employment has risen by perhaps 250 thousand; and unemployment (claimants), after allowing for the effect of the 1983 classification changes, has also risen by 150 thousand. Adding these two together gives the <u>working population</u> which may have risen by 400 thousand. This is much larger than the increase in the <u>labour force</u> which DE had projected on the basis of demographic factors and likely movements in participation rates. But:

(i) not all those people looking for work are claimants

and

(ii) not all claimants are looking for work.

Estimates of the labour force attempt to take account of both these factors by counting the numbers employed and the numbers who, while not employed, are looking for work. Clearly there are great difficulties in distinguishing between those loking and not looking for work; and the boundary will be affected by economic circumstances, most of all by the opportunities for employment.

An interpretation of the last year or so is that the extra jobs, many of them part-time jobs in service industries, were filled by people not on the unemployment register and by new entrants to the labour force; while the continuing job losses in manufacturing and elsewhere helped increase the numbers registered as unemployed (some of whom, no doubt, had virtually given up searching for work). Over the forecast period we expect growth in the population of working age to contribute about 100 thousand a year to labour supply growth. With some continuing increase in female partipation rates the labour force could rise by 125 thousand a year in total. If we are right in our forecast of employment rising by 150 thousand a year, then there is only a small gap which may be filled partly by taking in people not on the register and partly by people coming off SEMS. With wide margins of error on all the elements, our forecast of unemployment is basically for little change.

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Inflation

Some of the main competitive and cost influences on UK producer prices are shown in the following table:

per cent changes, in sterling, on a year earlier

	Prices charged by foreign manufacturers in the UK	Costs of UK manufacturers		UK producer prices*
		labour (including NIS)	imports	
1983	10	1½	7	5½
1984	8½	4½	10	6
1985	4½	4½	7	5½
1986	3½	5½	6	4½

*excluding food drink and tobacco

Abroad, inflation is generally low and this is reflected in low increases in the prices of imported manufactures in the UK from 1985 onwards, once sterling has as we assume stabilised. At home, costs are well under control, rising more slowly (with the help of NIS cuts) than prices. Capacity utilisation in manufacturing, as measured by the CBI regular surveys, is about average. In these circumstances, UK producer prices may rise a little more slowly in 1985 and 1986. Even so there should be some scope for further increases in profit margins for a time, though slower growth in the economy by 1986 may lead to the usual cyclical downturn in the profits share.

The RPI so far has turned out close to the budget forecast, despite the higher than expected April increase. Our forecast of the components is given in the table below (budget forecast in brackets):

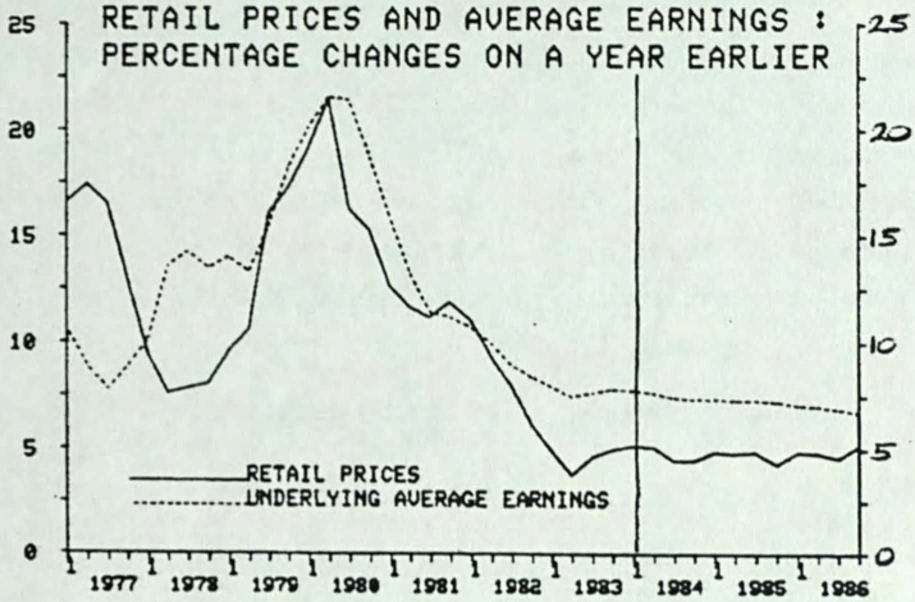
	Weights in total	per cent changes on a year earlier 1983 Q4	1984 Q4	1985 Q4
Food	20	6	4(3)	3½
Housing	15	6½	6(7)	4½
Nationalised* industries	9	1½	4(3½)	3
Other	56	5	4½(4½)	4½
Total	100	5	4½(4½)	4½

*including BT

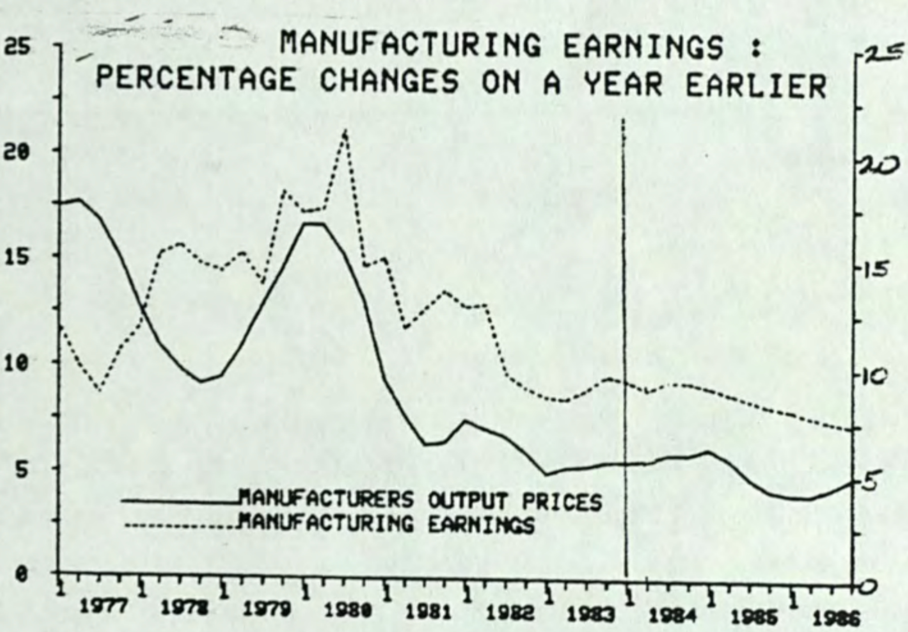
The forecast for Q4 1984 remains at 4½ per cent; other forecasters, though still averaging 5-6 per cent, are tending to come down. Our view of mid 1985 (4½-5 per cent) is a little higher than the budget forecast of 4 per cent reflecting higher import prices (mainly a lower pound) and higher interest rates.

The relation between prices and earnings in the whole economy and in manufacturing is shown in the charts below:

A. Total economy



B. Manufacturing



*For the whole economy we use the DE's 'underlying' earnings series which attempts to remove the effects of strikes (including miners), back pay etc.

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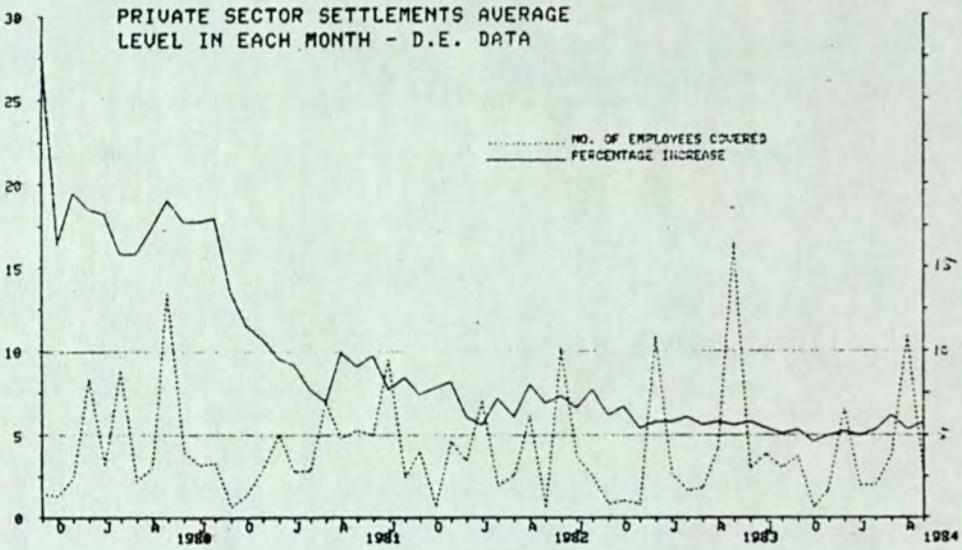
Earnings: background

Wage inflation has not changed much since late 1982: wage settlements have run at 5-6 per cent; and annual earnings increases have been fairly steady in the range $7\frac{1}{2}$-9 per cent. In manufacturing, earnings increases, underlying, and after allowance for changes in hours worked, have been in the range 8-9 per cent since August 1982. The chart below shows wage settlements over recent years, together with an indication of the proportions settling in each month, based on unpublished DE data.



The table overleaf shows the development of wage settlements, earnings and inflation over the last four pay rounds. Throughout this period, inflation turned out lower than outside forecasts; real earnings turned out higher than expected. Wage bargainers were prepared, in the period to summer 1982, to conclude settlements that provided for earnings increases lower than the expected rise in prices. Subsequently, autumn 1982 onwards, settlements were expected to lead to earnings growth only modestly ($1\frac{1}{2}$-2 per cent) above the level of expected inflation. But prices again rose less than expected and the cumulative difference over 3-4 years amounted to over 5 per cent.

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EARNINGS, INFLATION AND ANTICIPATED REAL EARNINGS GROWTH: WHOLE ECONOMY

percentage changes on a year earlier

	pay round 1980-81	1981-82	1982-83	1983-84 Estimates	1984-85 Forecasts
Wages					
Settlements outcome	8½	7	5½	5¼	
Underlying average earnings increase(a)	11½	9¼	7½	7½	7½
Inflation					
Outside forecasts for Q4 made in autumn of preceding year (b)	11.7	9.8	6.1	5½	[5-6]
Outturn (c)	11.9	6.2	5.1	4½	4½
Real gross earnings increase					
Anticipated (a-b)	-¼	-½	+1½	+2	2
Actual	-½	+3	+2½	+3	3
Real net earnings increase	-2½	½	+2½	3	3

Thus employees received higher than expected real wages before tax. But after tax and NIC increases in 1980 and 1981, the position is less clear: certainly in 1980 and 1981 tax and NIC increases led to a gap of 2-3 per cent or so in both years between gross and net earnings (see table). In the autumn of 1981 the level of wage settlements implied a small fall in real take home pay given the prevailing and prospective rates of inflation, after allowing for the sharp increase in taxation already announced in the 1981 Budget. But in 1982 and 1983 the level of wage settlements provided for an increase in real wages.

Although prices rose more slowly than forecast, the financial position of companies improved rapidly from the summer of 1981, and more than expected, helped by:

(i) large productivity increases, above all in manufacturing, partly induced by the high cost of labour;

(ii) the UK's terms of trade which turned out better than expected, increasing the real income of both employees and employers;

(iii) successive cuts in NIS.

These factors - particularly the coincidence of higher than expected real wages (for those in work) and higher than expected profits and company income - go a long way to explaining why the differences from expectations at the end of each pay round for both prices and real wages were not a major factor in the next set of negotiations.

The conclusion is that the disasters of 1979-80 led the labour market to deliver small falls in expected real earnings (before tax) in 1980 and 1981. But when these did not materialise, the pressure to correct earlier mistakes in subsequent wage negotiations proved weak.

Earnings: forecast

The current, 1983-84, pay round seems to be delivering settlements averaging $5\frac{1}{4}$ per cent, with earnings growth of about $7\frac{1}{2}$ per cent overall ($\frac{1}{2}$-1 per cent lower in the public services).

We expect price inflation as measured by the RPI to be around $4\frac{3}{4}$-$4\frac{1}{2}$ per cent in the autumn of 1984 and to stay about that rate in 1985. Outside forecasts for inflation in 1985 may by then be around 5 per cent or more. On the employers' side import costs may be rising at about 5 per cent from now on and the effect of wage costs on prices will be ameliorated by the cut in NIS as well as by a continuation, though perhaps at a slightly slower rate, of the recent large increases in productivity. The prices of competing imports, now some 8 per cent up on a year earlier, may be rising by only 3-4 per cent through next year. This would not allow a relatively large increase in wage costs to be passed on in higher price rises without loss of market share. But the rate of increase in private sector output is expected to continue to be buoyant at around 3 per cent; and company sector income in real terms may still be increasing. All these factors suggest that further increases in real earnings (pre-tax) are likely to be implied by wage negotiations and the outcome may again be better than expected if

a) prices rise more slowly than expected;

b) the fiscal adjustment in 1985-86 and beyond is used, as this forecast assumes, to cut personal taxes.

This is despite the considerable degree of spare capacity in the labour market, shown by the CBI survey results in the table below:

CBI Survey: Factors likely to limit output

Percentages

	April 1979	April 1981	April 1983	April 1984	Long-term average
Skilled labour	23	2	4	8	22
Other labour	6	0	1	1	7

All this suggests an earnings outcome in the 1984-85 pay round close to $7\frac{1}{2}$ per cent, as in the current pay round. Thereafter the evidence of inflation remaining low (assumed by then to be reflected in outside forecasts) and the big increase in after tax real earnings, helped by the assumed tax reductions in successive budgets, should gradually bring down settlement levels and rates of earnings growth.

Our basic judgments relate to private sector earnings. We assume nationalised industries get the same. For public services we assume that earnings growth will be about $\frac{1}{2}$ per cent a year less than in the private sector in each year. Because there is usually less drift in the public services this assumption on earnings implies that some public service settlements will be higher than in the private sector - as is the nurses' settlement just announced.

Percentage changes on a year earlier

Summary table: settlements and earnings growth

	Private sector & nationalised industries	Public services	Total
pay rounds (September-August): settlements			
1983-84	$5\frac{1}{4}$	$5\frac{1}{2}$	$5\frac{1}{4}$
1984-85	$5\frac{1}{2}$	$5\frac{1}{2}$	$5\frac{1}{2}$
1985-86	5	$5\frac{1}{2}$	5
financial years: earnings growth on previous year			
1983-84	8	$6\frac{1}{2}$	$7\frac{1}{2}$
1984-85	$7\frac{1}{2}$	$6\frac{1}{2}$	$7\frac{1}{2}$
1985-86	$7\frac{1}{2}$	$6\frac{1}{2}$	$7\frac{1}{2}$
1986-87	$6\frac{1}{2}$	$6\frac{1}{2}$	$6\frac{1}{2}$

Note: the settlements in one pay round eg 1983-84 are mainly reflected in earnings growth in the next financial year eg 1984-85.

Financial surpluses and deficits

The pattern of financial surpluses and deficits in the economy, past and forecast, is shown in the following table:

£ billion, current prices

	Private sector			Public sector	Overseas sector (- denotes surplus on UK current account)
	persons	companies	Total		
1982	10	4	14	-7	-6
1983	6	7	13	-11	-3
1984	7	6	13	-10	-1
1985	7	3	10	-7	-3
1986	8	0	7	-7	0

The measurement of these balances, depending on uncertain estimates of income and expenditure, is subject to substantial uncertainty and revision. In the case of the company sector, for example, there are enormous measurement problems some of which imply that the figures for the financial surplus do not give a true picture.

Part of these shifts in surpluses and deficits reflect changes in in- inflation: the personal sector, a large holder of monetary assets, tends to save less when inflation is low (and when the real value of those assets is being eroded only slowly).

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Financial Forecast

US interest rates may edge up further in the second half of this year and perhaps a little further after the election. In 1985 and beyond (we assume) the growing likelihood of cuts in the fiscal deficit in the later 1980s leads to a levelling out and then a fall in nominal rates with rather more fall in real rates as inflation gradually picks up. But we expect real interest rates to remain high by postwar standards, not merely because of the lack of co-ordination of fiscal and monetary policies in the US but also as a continuing reaction to the low level for much of the 1970s of interest rates when they failed to give enough weight to inflation and to lending risks.

UK short-term interest rates are currently some 2 points below US rates; the key question is whether the further rise forecast for US rates will require either a rise in UK rates, or a fall in sterling. We have opted for little change in either in the short term, implying an increase in the differential between US and UK interest rates of about a further point. Even so, the resulting differential, of up to 3 points, is not large compared to the possible fall in the dollar/sterling rate nor to the differential between dollar rates and other currency rates (eg Germany, Japan).

Many UK commentators are expecting inflation rates of 6 per cent in 1985. At some stage, we assume, these expectations will come more into line with our forecast, allowing nominal interest rates, both short and long, to begin coming down again, consistently with meeting monetary targets.

UK interest rates might develop as follows:

	Short-term (3 month interbank)	Long term (20 year gilt)	Mortgage rate
1983 Q4	$9\frac{1}{2}$	$10\frac{1}{2}$	$11\frac{1}{4}$
1984 (mid June)	$9\frac{1}{2}$	11	$10\frac{1}{4}$
1984 Q4	$9\frac{1}{2}$	$10\frac{1}{2}$	11
1985 Q4	9	10	$10\frac{1}{4}$
1986 Q4	8	9	10

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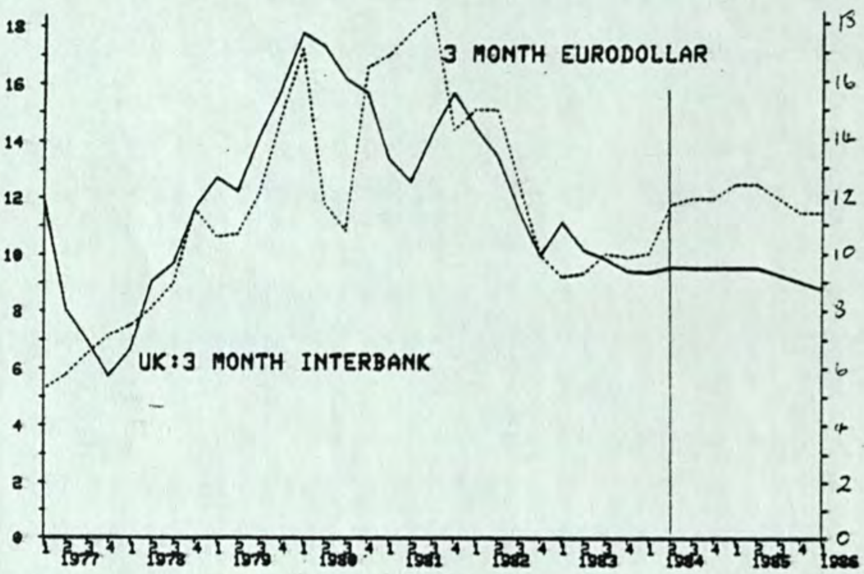
INTEREST RATES, PERCENT



Monetary aggregates

The main influences on MO are thought to be personal incomes, a proxy for transactions, the level of short-term interest rates and increasing use of bank accounts and, perhaps, credit cards etc. MO grew by 6 per cent at an annual rate over the 1983-84 target period. We assume little change in the trend rise of velocity over the forecast period, and with the growth of incomes and the average level of interest rates expected to be much the same this year as last, MO might again increase by 6 per cent in 1984-85, putting it at the middle of its target range. Thereafter, despite some fall in interest rates, MO growth might slow to 4-5 per cent, mainly due to a slowdown in the growth of personal income.

While MO is mainly held for transactions purposes, £M3 is much more a store of wealth and is therefore heavily influenced by the evolution of the financial wealth of the private sector. A smaller private sector financial surplus and slower growth of bank credit lead, in the forecast, to a slower rate of increase in gross financial wealth this year compared with last. This is the main reason we see some fall in the growth of £M3, from about 9½ per cent in the last target period to 8 per cent in 1984-85. The growth of wealth is expected to level off somewhat thereafter, but £M3 may continue to slow down, to remain comfortably within its target range.

The £M3 forecast can also be presented in terms of the familiar counterparts analysis, as in the table below:

£ billions

	PSBR	Debt Sales	(of which gilts)	Bank Lending	External and Other Adjustments	£M3
1983-84	9.7	12.4	(9.8)	15.4	-4.5	8.2
1984-85	6.2	7.5	(5.1)	14.7	-5.0	8.4
1985-86	7.0	7.0	(4.2)	14.0	-6.2	7.8
1986-87	7.2	6.5	(4.0)	13.3	-6.4	7.6

The table shows that slower growth of £M3 may be consistent with a much lower rate of net gilts sales to the non-bank private sector in future than in the recent past even if the pace of bank lending slows only slightly. A major reason is the fall in the PSBR, a fall which contributes to the fall in the private sector financial surplus noted in the discussion of financial wealth although the capacity of the market to absorb gilt sales will be reduced a little by the programme of asset sales. This will also tend to reduce the volume of new issues.

The figures for gilts sales in the table understate the funding requirement however because they are net sales to the non-bank private sector only. A more complete picture is given below:

£ billion

	Net sales to: Non-bank private	Overseas	Banks	Redemptions	Gross Sales
1983-84	9.8	1.1	0.7	3.7	15.4
1984-85	5.1	0.9	0.4	4.2	10.6
1985-86	4.2	0.7	0.4	5.9	11.2
1986-87	4.0	0.7	0.4	8.7	13.8

The forecast implies very little net over-funding over the next few years. Further discussion of gilts sales, particularly in the context of the institutions' flow of funds, is contained in the separate report on the Financial Forecast.

PSL2 has been growing more quickly than £M3 since the middle of last year and ended 1983-84 well above the top of the target range. This is mainly because of relatively fast growth in building society deposits. This pattern of building societies gaining share at the expense of the banks is likely to continue over the forecast period, as the societies adjust their interest rates more rapidly to market conditions and continue to expand their range of services. Even so the rate of growth of building society inflows and PSL2 should slow down, in line with personal wealth and income.

All the monetary aggregates are forecast with a large margin of error, but the limited life for M2 makes it particularly difficult to handle. Most of M2 is held by the personal sector and so we forecast it from a detailed look at the personal flow of funds. This suggests that M2 might continue to grow at recent rates over the next year but then decelerate with personal sector disposable income. The forecast of M2 and the other monetary aggregates is summarised in the table and chart below:

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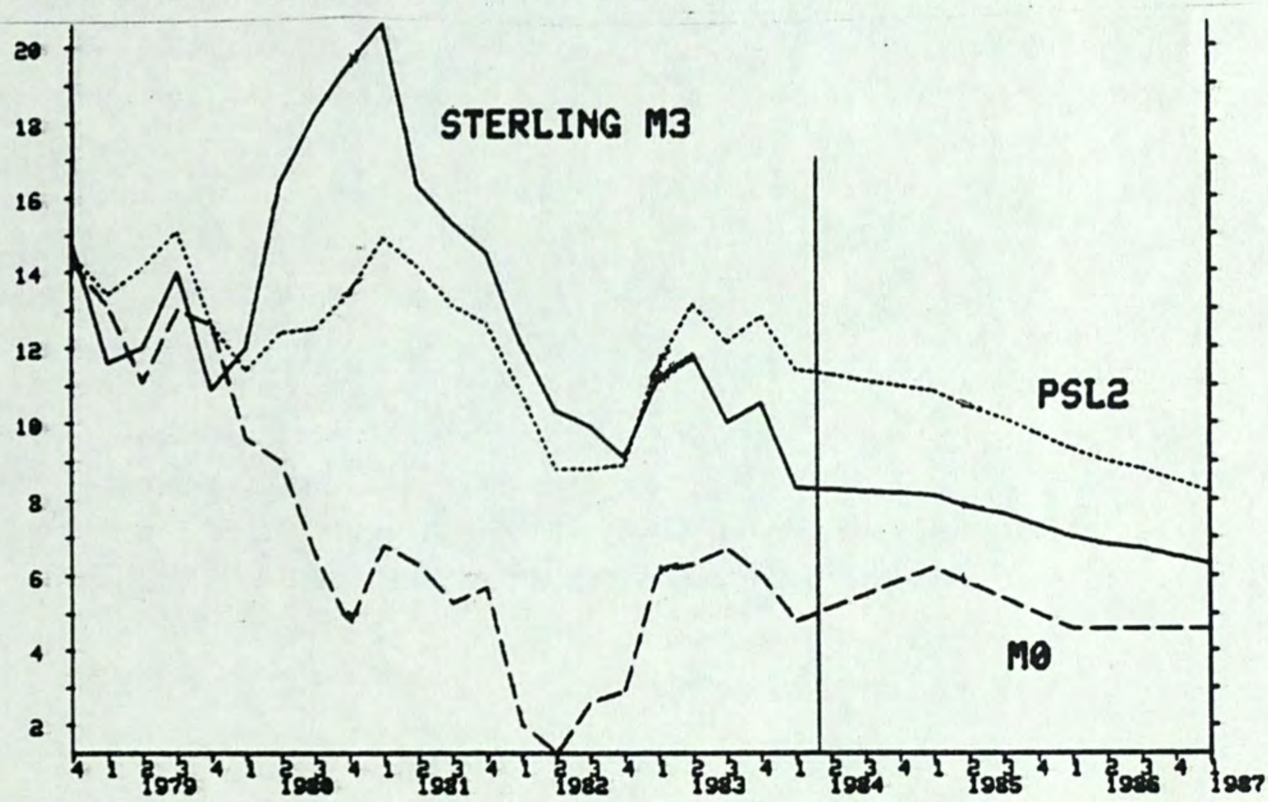
Per cent per annum

	M0		£M3		M1	M2**	PSL2
	Target	Outturn/ Forecast	Target Range	Outturn/ Forecast	Outturn/ Forecast		
<u>Target Periods</u>							
1982-83	-	4½	8-12	11*	12½	9½	11½
1983-84	-	6	7-11	9½*	14	10½	13
1984-85	4-8	6	6-10	8	11½	9½	11
1985-86	3-7	4½	5-9	7	9	8	9½
1986-87	2-6	4½	4-8	6½	8½	6½	8

*including public sector deposits

**April-April

MONETARY AGGREGATES PERCENTAGE CHANGE ON YEAR EARLIER



ANNEX: COMPARISON OF FORECASTS

Treasury Forecasts

1. Table A compares the current Treasury forecast with the last three budget forecasts and the autumn statement published in November.

2. The outlook for GNP growth this year is fractionally lower than in the budget forecast as the effect of the assumption concerning the miners' strike outweighs an upward revision to estimated oil production. Next year's forecast, however is higher because of the recovery from the strike affected level. Foreign interest rates are now expected to be slightly higher this year and so the forecast exchange rate a little lower. RPI inflation is slightly higher.

Outside Forecasts

3. Table B compares the Treasury forecast with an average of outside forecasts. The estimate for GNP growth this year is almost identical to the average of a fairly wide range of outside forecasts but 1985 growth is distinctly higher. This is in part a result of a higher Treasury forecast of real personal disposable income because inflation in 1985 is lower than that in all outside forecasts while earnings are growing at much the same rate. The same feature is present in the 1984 projections but to a lesser extent. It probably stems from a combination of faster growth in productivity, a slower rise in profit margins and lower import prices.

4. The PSBR forecast for the current year is now somewhat lower than the average of other assessments but the difference is well within the margin of error.

TABLE A

COMPARISON OF TREASURY FORECASTS

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Money Supply £M3 (% Change on year earlier)					
1982 Q1	14.5 (15.5)	13.8	13.8	14.2	14.1
1983 Q1	11.1 (11.6)	9.7	10.2	11.0	11.0
1984 Q1	8.9 (9.2)	9.0	9.9	9.5	9.5
1985 Q1	7.0 (7.3)	8.8	9.2	9.2	8.1
1986 Q1		7.5	8.0	8.2	7.0
PSBR £ billion (% of money GDP)					
1981-82	10.6 (4.2)	8.7 (3.4)	8.8 (3.4)	8.8 (3.4)	8.6 (3.4)
1982-83	9.5 (3.4)	7.5 (2.7)	9.2 (3.3)	9.2 (3.3)	8.9 (3.1)
1983-84	8.4 (2.8)	8.2 (2.8)	10.2 (3.4)	10.0 (3.3)	9.7 (3.2)
1984-85	6.7 (2.0)	8.0 (2.5)	8.1 (2.5)	7.2 (2.2)	6.2 (1.9)
1986-86	7.3 (2.0)	7.0 (2.0)	7.0 (2.0)	7.0 (2.0)	7.0 (2.0)
Fiscal Adjustments (£ billion)*					
1982-82	-	-	-	-	-
1982-83	-	-	-	-	-
1983-84	-0.3	-	-	-	-
1984-85	-2.1	-0.4	0.5	-	-
1985-86	-	- 3.8	-3.8	-1.9	-0.8
Nominal GDP (mp) (% Change on year earlier)					
1981	10.1	9.6	9.7	9.9	9.9
1982	10.6	8.8	9.3	9.5	9.5
1983	9.2	7.5	8.4	8.6	8.6
1984	9.9	8.6	8.0	8.1	7.3
1985	9.0	7.9	7.6	6.9	7.7
RPI (% Change on year earlier)					
1981 Q4	11.9	11.9	11.9	11.9	11.9
1982 Q4	9.0	6.2	6.2	6.2	6.2
1983 Q4	7.1	5.8	5.2	5.0	5.0
1984 Q4	6.0	5.4	4.2	4.3	4.5
1985 Q4	6.1	5.2	4.6	4	4.3

* A negative sign indicates a reduction in taxation

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Labour Cost Competitiveness					
(Ratio of UK to competitors costs 1975 = 100) **					
1981 Q4	139.3	131.4	102.4	102.4	100.5
1982 Q4	136.2	132.2	98.5	102.9	99.5
1983 Q4	130.3	121.0	91.0	98.5	95.2
1984 Q4	129.8	121.0	90.5	98.2	93.9
1985 Q4	129.1	118.6	92.1	97.1	95.4
Current Balance (£ billion)					
1981	8.3	6.0	6.6	7.3	7.3
1982	4.2	4.0	5.4	5.5	5.8
1983	2.9	1.5	0.6	2.1	2.9
1984	3.3	1.5	0.1	2.2	1.3
1985	3.3	-0.6	1.1	0.7	2.5
Manufacturing Output=					
(% Change on year earlier)					
1981	-6.4	-6.4	-6.6	-6.4	-6.4
1982	3.2	-0.6	0.4	0.1	0.1
1983	2.2	1.8	1.3	1.5	1.9
1984	1.9	2.4	2.8	3.6	3.0
1985	1.3	1.9	1.4	2.1	1.7
GDP Volume (fc)					
(% Change on year earlier)					
1981	-2.0	-2.5	-1.6	-1.4	-1.4
1982	1.4	0.7	1.8	2.0	2.0
1983	2.4	2.0	2.8	2.8	3.0
1984	2.8	2.7	2.9	3.1	2.9
1985	2.2	2.4	2.8	2.5	2.9

** FOR COLS 3-5 1980 = 100

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	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Interest Rates %					
Short Term					
1981-82	14.2	14.2	14.2	14.2	14.2
1982-83	13.5	11.3	11.5	11.5	11.5
1983-84	11.9	9.6	9.6	9.7	9.7
1984-85	10.2	7.8	8.3	8.7	9.5
1985-86	8.9	7.4	8.1	7.8	9.1
World Trade in Manufactures UK Weighted					
1981	4.1	3.3	3.3	3.3	3.0
1982	4.0	-3.3	-3.1	-2.8	-1.8
1983	4.6	1.0	-0.7	1.3	-0.2
1984	5.5	6.6	5.3	5.1	5.4
1985	4.5	5.7	6.3	4.5	5.6
UK Exports of Goods and Services (% Change on year earlier)					
1981	-1.5	-2.3	-2.0	-2.0	-2.0
1982	3.3	0.7	1.4	1.5	1.2
1983	3.7	0.9	0.6	0.6	0.8
1984	4.4	5.0	4.0	5.0	6.3
1985	4.0	4.9	3.9	3.9	3.7
Average Earnings (private, not cyclically adjusted - % Change on year earlier)					
1981 Q3	13.2	10. 0	9.4	10.0	10.9
1982 Q3	10.1	10.0	10.1	9.8	9.9
1983 Q3	8.3	7.3	8.4	8.3	7.9
1984 Q3	7.5	7.0	7.3	7.5	7.3
1985 Q3	6.9	6.5	6.4	7.3	7.5

	1982 FSBR/MTFS	1983 FSBR/MTFS	1983 A.S.	1984 FSBR/MTFS	June 1984 FORECAST
Effective Exchange Rates					
1975 = 100					
1981	94.9	94.9	94.9	94.9	94.9
1982	88.5	90.6	90.6	90.6	90.6
1983	84.6	80.5	83.4	83.3	83.3
1984	81.9	81.8	83.6	83.2	80.1
1985	81.4	80.8	83.0	83.5	80.7
Unemployment (UK sa excl school leavers - millions, new definition)					
1981 Q4	2.6	2.6	2.6	2.6	2.6
1982 Q4	2.8	2.9	2.9	2.9	2.9
1983 Q4	2.8	2.9	2.9	2.9	2.9
1984 Q4	2.8	3.0	2.9	3.0	3.1
1985 Q4	2.8	3.1	2.8	3.0	3.1
I & C Companies' Financial Surplus/ Deficit, £ billion					
1981	1.4	2.0	2.7	2.7	3.3
1982	0.2	1.1	2.3	2.5	3.6
1983	-1.8	0.7	4.8	6.4	6.7
1984	-0.9	2.3	4.6	5.1	5.4
1985	-0.4	1.8	5.0	2.0	1.9

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TABLE B COMPARISON WITH OUTSIDE FORECASTS

	TREASURY June 1984	OUTSIDE FORECASTS Consensus		Range
£M3 % change in year				
1984-5	7.8	8.3	7.1(S&C)	9.9(P&D)
1985-6	8.1	8.2	7.0(NIESR)	10.6(Henley)
£Mo % change in year				
1984-85	6.2	5.4	5.3(S&C)	5.7(P&D)
1985-86	4.6	6.4		
PSBR £ bn				
1984-5	6.2	7.6	6.9(S&C)	9.7(NIESR)
1985-6	7.0	7.4	5.4(LBS)	9.2(NIESR)
Exchange rate 1975 = 100				
1984 Q4	79.6	81.8	81.0(S&C)	82.0
1985 Q4	81.0	80.7	77.9(NIESR)	84.0(LBS)
Current account £ bn				
1984	1.3	1.2	0(LBS)	2.7(Liverpool)
1985	2.5	1.3	-0.3(NIESR)	3.0(Liverpool)
Average earnings % change on year earlier				
1984	7.2	7.4	6.9(Cambridge)	7.2(P&D)
1985	7.5	7.5	6.2(NIESR)	8.0(Henley)
RPI(CED*) % change on year earlier				
1984 Q4	4.5	5.2(5.6)	4 3/4(CBI)	6.0(NIESR)
1985 Q4	4.3	5.9(5.6)	5½ (CBI)	6.0(NIESR)
* LBS				
RPDI % change on year earlier				
1984	3.2	2.5	1.3(LBS)	3.1(CBI)
1985	3.1	1.9	1.3(LBS)	2.5(P&D)
Import volume: goods & services % change				
1984	7.6	6.3	4.5(CBI)	9.0(P&D)
1985	3.5	3.1	1.4(P&D)	4.5(CBI)
Export volume: goods & services % change				
1984	6.3	6.0	3.6(CBI)	7.8(S&C)
1985	3.7	3.5	2.7(S&C)	4.4(Henley)
GDP volume % change				
1984	2.9	2.8	1.9(NIESR)	3.4(P&D)
1985	2.9	2.1	1.4(Cambridge)	2.4(S&C, P&D)
Unemployment (millions)				
1984 Q4	3.07	2.98	2.91(LBS)	3.0(NIESR, Henley)
1985 Q4	3.06	2.98	2.81(LBS)	3.1(S&C)