10 DOWNING STREET

Prime Minister

See page 3 of the Phillips and Drew forecast, attached, ~~[illegible]~~ published on Friday.

DLW
27/11

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Policy assessment

The forecasts that follow are based on the policy changes and assessments given below.

MAIN POINTS THIS MONTH

★ **Autumn Statement** suggests continuation of strong sterling policy underpinned by high interest rates; but financial markets now worried by drifts in Government's policies.

★ **PSBR target** for 1986/87 at £8bn (cf £7½bn in MTFS) with £2-2½bn of tax relief. PSBR outturn forecast at £9bn.

Autumn Statement

There is growing uncertainty about the direction of the Government's economic policies; uncertainty which the Autumn Statement signally fails to dispel. The Medium Term Financial Strategy was once intended to give clear signals and to inform public debate. More than anything else, it was seen as a constraint on profligate economic policies. Now the signals are muffled and key information is suppressed. As a result, financial markets are being asked to take a lot on trust. But 10 months after a sterling crisis, trust is in short supply.

We identify three main areas of concern. First, while we welcome the suspension of the target for broad money supply, £M3, we lament the absence of an acceptable alternative. Markets had learnt that a tight target for £M3 meant a tight target for public borrowing. That check on profligacy has now gone. The upward revision in the Autumn Statement for this year's PSBR — from £7.1bn to £8bn — seems to be only a taste of what is to come.

Secondly, the Government has shifted its attitude towards public expenditure. It has now adopted a 'middle way' approach, making a virtue out of persistent spending overshoots. The relatively trouble-free negotiations between Treasury and spending ministers this year suggests that the increase of £4bn in planned programme expenditure next year — details below — is more a reflection of a shift towards fiscal ease than of mere problems of control.

Thirdly, there is no suggestion in the Autumn Statement that the rapid extension of the Government's privatisation programme — to a £4.75bn for 1986/87 in the Autumn Statement from £2.25bn in the Budget — will be reflected in a planned reduction in the PSBR.

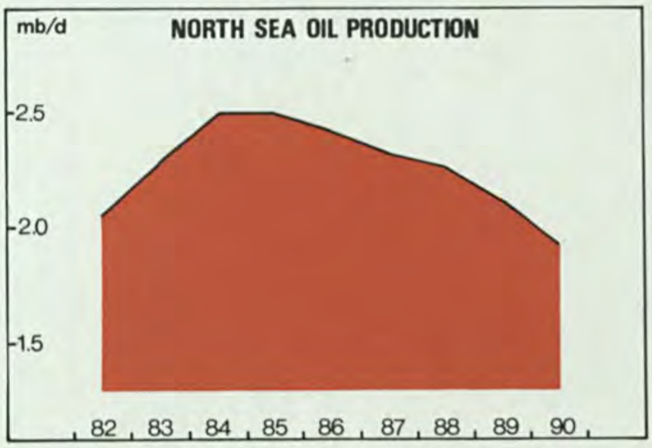
The overriding consideration appears to be the political one of income tax cuts. The Chancellor's refusal to publish a revised 1986/87 fiscal adjustment (the Treasury code for tax cuts) put at £3.5bn in the Budget forecast can only add to the financial market's unease.

In our view, the Chancellor's game plan is to combine an easing of fiscal policy with firm monetary policy — a 'touch of Reaganomics'. A combination of high real interest rates and sterling at an uncompetitive level is intended to keep inflation in check, especially by suppressing imported inflation.

The suppression of imported inflation is required at a time when pay is rising and productivity growth slowing, putting upward pressure on unit wage costs. Firm sterling helps contain the threat to the Government's inflation objectives. If successful, it allows the Chancellor to ease fiscal policy by a few notches to keep growth going.

As inflation falls on the back of lower import prices into 1986, some relaxation of fiscal policy should appear more acceptable to markets than it does now. Two key dangers remain, however. The first is pay. If pay were to continue to escalate on the back of tight labour maket conditions, the chances of steady growth with low inflation would evaporate.

The second danger is financial confidence. The Chancellor has to convince markets that relaxation of fiscal policy does not mean relaxation of monetary policy. The Autumn Statement forecast for the housing element of retail prices appears to imply, at most, a point reduction in interest rates by end-1986. This is realistic in our view. Base rates of 10 per cent or above are the best we hope for in 1986. The great fear is that at some stage the Government may be tempted to relax fiscal policy and monetary policy together. This would be to repeat the policy error of 1984. Result: sterling crisis. Interest rates have to stay high and the Chancellor has to take the muddle out of the MTFS.



1986 Budget

Even with an extra £2bn contingency reserve and £7½bn PSBR target for 1986/87, the current MTFS envisages scope for a positive 'fiscal adjustment' of £3½bn in the financial year. We think that the persistent overrun in public spending is likely to eat into this amount, perhaps leaving room for a net injection of only £2-2½bn on the personal direct tax front in the 1986 Budget, even though asset sales have been raised to £4¾bn from £2¼bn for 1986/87 in the present MTFS. Accordingly, the forecasts in this issue are based upon the assumption that £2¼bn tax relief is distributed by the Chancellor next year.

The PSBR target for 1986/87 could be raised to £8bn on the argument that it would still be consistent with a low inflation outcome. In practice, the PSBR in 1986/87 could turn out closer to £9bn.

Medium term judgement: The declining profile of North Sea output suggests that the preservation or improvement of cost competitiveness will be paramount in the years ahead. But the adjustment will be made less easy by a buoyant rate of 'core inflation' represented by unit labour costs. Only a modest fall in sterling is likely to be deemed acceptable. As regards tax relief, we assume a net £2bn pa is made available in each of the fiscal years 1987/88 and 1988/89. Even so, the tax reduction is less than that implied by the 1985 MTFS. Our assessment of the medium term outlook is presented on pp 22-23.

Economic Assumptions

The forecasts that follow are based on the economic assumptions given below.

MAIN POINTS THIS MONTH
- ★ **UK export market growth** of 4% in 1986 and 4¼% in 1987 after 4¾% in 1985.
- ★ **OECD inflation** to escalate gradually to around 5½% by end-1987.
- ★ **Non-oil commodity prices** in SDR terms to show a modest recovery in 1986 and 1987.
- ★ **Average oil price** to weaken slightly in dollar terms in early 1986, stabilising in nominal terms thereafter.

Export Markets

World trade volumes were boosted in 1984 by the remarkable growth in US imports — up 30% on 1983. Buoyant US demand stimulated trade in the rest of the world, especially the industrial countries. Weighted by importance to the UK, export markets for UK products probably grew by 8% in 1984.

Events in 1985 are dominated by the slowdown in US growth, from nearly 7% in 1984 to an annualised rate of only 2% so far this year. US import demand growth, partly responsible for the slowdown in overall US growth, is forecast at 10½% in 1985. Japanese growth is also likely to slip. Modest growth in Europe, with which the UK has close trade ties, helps secure 4¾% growth in UK export markets in 1985.

With import growth in the USA falling to under 4% in 1986 and 1987, though offset by maintained, if not more buoyant, trade growth elsewhere, UK export markets may grow by less than 4% in 1986 and only 4¼% in 1987.

OECD Inflation

Though some concern may start to develop about US inflation prospects, the general inflation outlook for the OECD area remains encouraging. In the USA, inflation, currently under 3½%, looks set to escalate over the next 18 months, reflecting the impact of a productivity slowdown and a weaker dollar. In Germany, inflation is likely to stay within the 2-3% range this year and next. In the OECD area as a whole, consumer prices may rise by around 4½% in 1985, down from 5¼% in 1984.

There is little reason to expect any major escalation of inflation in 1986; indeed, in Europe, inflation may fall slightly. By end-1987, however, rising US inflation may push the OECD average back towards 5½% although this would still be below the cyclical trough rate experienced in the 1970s between the two oil crises. It would mark a return to the inflation performance of the late 1960s/early 1970s.

Non-Oil Commodity Prices

Given the volatility of exchange rates, we find it more useful to assess trends in non-oil commodity prices in terms of SDR-based measures rather than by reference to indices denominated in any specific currency. In these terms, metal prices have relapsed in recent months after showing signs of tentative recovery earlier in the year. By the end of this year we assume that prices will have recorded a 9½% decline from end-1984 levels. In the course of 1986, some recovery in US industrial production and a possible resurgence in speculative interest primed by a rise in gold could well provide some price stimulation. We look for an advance in metal prices to leave the end-1986 level about 9½-10% higher than end-1985, with a 5% rate of increase assumed thereafter. As regards food prices, these have been weak and we expect them to end 1985 substantially lower than at end-1984. A modest recovery has been assumed for 1986 and 1987. Overall, these assumptions lead us to expect aggregate non-oil commodity prices to record a 10½% year-on-year decline to end-1985 in SDR terms. A pick-up starting early next year should limit the calendar 1986 decline to 2½%, giving way to a 3-3½% average year rise in 1987.

Oil

Spot crude markets have remained firm over the last month. Crude liftings have been low through the summer causing shortages in the spot market. For this reason, spot prices are generally above refinery net back, prices at which crude is normally available from OPEC. This situation has not existed for a long time. The October OPEC meeting ended without any agreement. Production quotas for individual members remain a source of contention and there is little adherence to official prices. We expect spot crude prices to remain firm in the coming months, as restocking ahead of winter demand occurs. The next major test of spot prices may be delayed until next spring when we assume a $1-2/bl fall in the price of Arab heavy taking it to around $24/bl. Against the background of a weaker dollar this implies a significant price reduction in real terms.

TABLE 1: Economic assumptions

	10-year average growth	*1985*					*1986*					*1987*				
		Q1	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*
Export markets	L	115.1	116.3	117.2*	117.9	**116.6**	119.3	120.6	121.9	122.7	**121.1**	124.2	125.7	126.9	128.0	**126.2**
(1980 base)	3.6	5.6	5.2	4.6*	3.4	**4.7**	3.6	3.7	4.0	4.1	**3.9**	4.1	4.2	4.1	4.3	**4.2**
OECD inflation	L	135.7	137.7	138.6*	140.1	**138.0**	141.7	144.0	145.3	147.5	**144.6**	149.1	151.6	153.0	155.5	**152.3**
	9.6	4.6	4.8	4.5*	4.4	**4.6**	4.4	4.6	4.8	5.3	**4.8**	5.2	5.3	5.3	5.4	**5.3**
Index of commodity	L	102.5	99.2	92.0*	89.7	**95.9**	91.8	93.2	94.0	94.6	**93.4**	95.0	95.9	96.8	97.8	**96.4**
prices SDR	7.1	−7.5	−9.6	−9.8*	−10.5	**−9.3**	−10.4	−6.0	2.2	5.5	**−2.6**	3.5	2.9	3.0	3.4	**3.2**
Index of commodity	L	112.1	103.6	96.9*	98.0	**102.7**	99.5	101.1	101.7	103.0	**101.3**	103.4	104.1	105.0	106.8	**104.8**
prices food SDR	10.4	−4.9	−14.9	−15.1*	−10.9	**−11.5**	−11.2	−2.4	5.0	5.1	**−1.3**	3.9	3.0	3.2	3.7	**3.5**
Index of commodity	L	89.7	90.9	82.6*	77.4	**85.2**	81.4	83.3	84.8	84.9	**83.6**	85.4	87.3	89.1	89.4	**87.8**
prices metals SDR	2.4	−5.9	−1.2	−3.2*	−9.4	**−4.9**	−9.3	−8.4	2.7	9.7	**−1.8**	4.9	4.8	5.1	5.3	**5.0**
Imported oil price	L	26.6	25.6	25.3*	25.5	**25.8**	25.0	24.0	24.0	24.0	**24.3**	24.0	24.0	24.0	24.0	**24.0**
Arab heavy $/bl	26.3	0.1	−5.0	−5.4*	−3.9	**−3.6**	−6.0	−6.4	−5.1	−5.9	**−5.8**	−4.0	0.0	0.0	0.0	**−1.0**