NW to see

DW - thank you

N.L.W.

7.7

10 DOWNING STREET

From the Private Secretary

Prime Minister

This makes depressing reading I am afraid.

See in particular:

- the covering minute
- the summary starting on page 3
- the table on page ~~50~~ 27
- pages 51 and 52 on unemployment.

The main impression is of an economy <u>failing to take advantage of lower</u> oil <u>prices in the way our competitors are</u>, and with pay still the heart of our problems.

DW 4/7.

SECRET

10 11

COPY NO 54

FROM: H P EVANS

DATE: 24 June 1986

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC members
Mr Burgner
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Monger
Mr Sedgwick
Mr Spackman
Mr Turnbull
Mr Matthews
Mr Davies
Mr Mowl
Miss O'Mara
Miss Peirson
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

TREASURY ECONOMIC FORECAST: JUNE EXERCISE

I attach a copy of the main report on the June forecast, which makes the same assumptions about UK economic policy as were made in the FSBR and is based on the same oil price assumption. ie $15

2. We have reviewed the judgements made in the FSBR forecast in the light of their internal plausibility and their conformity with recent data. In quite a number of respects, the position in the first half year seems to be turning out differently from expectations. With the exception of the RPI inflation rate (and that to a large extent because of mortgage interest rates) the first half of 1986 looks worse than expected: activity is lower,

unemployment is higher, real wages are higher, and the balance of payments position is less favourable. Like many other forecasters, including the London Business School, we have concluded that growth and inflation will both be lower this year, but that growth will be better next year.

3. In one important respect at least our judgement at Budget time looks to have been too optimistic. Exports have been much lower than expected, reflecting both a weaker world position and, we think, a less favourable UK share. Partly as a result, but mainly because of the big fall in oil revenues, we may now be entering a period in which the current account fluctuates not all that far from balance - a move away from the substantial surpluses of recent years. The timing of this move will depend crucially on the relative growth of domestic demand here and abroad.

4. Another aspect of recent developments is that we do not seem to be getting any gain in competitiveness following the fall in oil prices. This results from a smaller than expected fall in the exchange rate, and from faster inflation in the UK compared with other major countries. But we do see low inflation rates both this year and next. Because we cannot count on further gains on commodity prices, one major factor reducing the rate of inflation this year will fade away. While there should certainly be some offset from the (delayed) response of domestic costs, there may still be some mild tendency for inflation to rise during 1987. That tendency is likely to be exaggerated by the RPI, if we are anything like right about the movement of mortgage interest rates.

5. One message from this forecast is that we need to watch carefully for signs of continued weakness in demand and prices, as much abroad as at home. In constructing this forecast we have had in mind the sentence from the FSBR (paragraph 2.30) that "the MTFS .... provides as firm a guarantee against inadequate money demand as it does against excessive money demand". With money GDP

in 1986-87 now expected to rise a full 1 per cent less than at Budget time, and with only part of that made up in 1987-88, this forecast suggests that the scope for reducing interest rates this year could be bigger than we have allowed. If so, there would also be the possibility of a sharper rise in rates next year.

HPE

H P EVANS

TREASURY ECONOMIC FORECAST

JUNE 1986 REPORT

Contents **Page**

TREASURY ECONOMIC FORECAST: JUNE 1986

Report by EA

Introduction

This is the report on the internal June exercise. Detailed reports are being circulated as follows:

World economic prospects, Mr Matthews (EF2).

Public finances, Miss Peirson (PSF).

Oil production and revenues, Mr Owen (EA2).

Financial forecast, Mr Mowl (EA2).

2. In general, we follow the policy framework of the MTFS. The forecast overs the period to early 1988, in summary pages 3-14, and in detail pages 15-57.

3. Because of temporary technical problems with our printer, we are unable to adopt the usual rounding to halves or quarters. Instead, in many tables, the figures are quoted to one decimal place. This should not be taken as an indication of greater than usual confidence in the forecasts.

SUMMARY

3. Since the budget forecast was prepared, there has been plenty of evidence that the world economy - industrialised countries and primary producers alike - has been weaker than expected. A crucial element in our assessment is the extent to which the weakness in UK output, particularly evident in the manufacturing sector, and lower UK inflation reflects world developments.

4. Our conclusion - based on uncertain data for only a short period thus far in 1986 - is that not all the weakness in the UK can be attributed to developments elsewhere. In at least one crucial aspect, the performance of exports relative to world trade, the budget forecast took what now looks to be an overly optimistic view.

5. With both world output and prices weak, this has provided scope for more falls in interest rates, here and abroad. From the second half of 1986 in particular, we think, the benefits from lower prices and lower interest rates will stimulate demand and activity. So although 1986 is weaker, 1987 may show stronger growth combined with low inflation. Our revised forecast for the UK is as follows:

	GDP		RPI	
	percentage changes		calendar years (fourth quarters in brackets)	
	FSBR	June	FSBR	June
1986	3.1	2.4	3.8(3.6)	3.1(2.3)
1987	2.4	3.1	3.7(3.3)	3.3(4.0)

6. We have based this forecast on a $15 barrel world (and UK) oil price from about now. Although this is rather higher than spot or futures prices at the moment, analysis by the Department of Energy suggests that a substantially lower price, like $10, was probably not sustainable in the longer term. On balance, we felt there was no strong case for a major change in the oil price assumption.

Activity: World and UK

7. There was a fairly widespread weak first quarter. There was a small fall in manufacturing output in the UK, and in parts of Europe, and US output growth was sustained only by some involuntary stockbuilding. In addition, the recent fall in UK exports to many primary producers suggests weak demand there too. Early signs - production figures for UK, France and Germany in particular - point to some recovery in the second quarter, as we have assumed, but the latest CBI survey results for the UK are again distinctly weak.

8. Large increases in real income for both consumers and companies are the main reason for expecting domestic demand to become more buoyant. But on our forecast it could be well into the autumn before there are convincing signs of upturn. This could follow the usual pattern in which manufacturing output rises faster than total:

per cent changes

	GNP/GDP		Industrial/manufacturing output	
	Major 7	UK	Major 7	UK
1986	2.8	2.4	2.3	0.5
1987	3.6	3.1	5.6	3.4

Unemployment

9. The weakness in manufacturing output in the UK in recent months seems to have been quickly reflected in the labour market, with the trend of unemployment (discounting the effect of Selective Employment Measures) rising at some 20 thousand a month in the last half year. The renewed upturn in activity forecast may be enough to halt and perhaps reverse the trend in unemployment. But most forecasts in recent years underestimated the rise in unemployment (see chart on page 48).

Interest Rates

10. There is some downward pressure on interest rates in many OECD countries because of the weakness in both output and prices. We expect rates both here and abroad to fall slowly for a while. But with a somewhat faster growth of output established by 1987 and with the inflation rate tending to rise from very low levels once the direct effects of lower oil and commodity prices have been passed through, there may be some tendency for interest rates to rise next year.

Monetary policy targets and indicators

per cent changes

	Money GDP		£M3		MO	
	F'Cast	MTFS	F'cast	MTFS range	F'cast	MTFS range
1985-86	9.7	9.5	13	(5-9)	4.4	3-7
1986-87	5.8	6.8	17	11-15	4.0	2-6
1987-88	7.0	6.4	14	-	5.1	2-6

11. We have raised our forecast of £M3 growth in 1986-87 in the light of recent data. Wider aggregates show more stable growth. Much of the extra credit to consumers is taking the form of mortgages, and with the amount of mortgage lending rising in real terms, and the supply of houses only responding very slowly, house price rises may continue in double figures. (This price rise is not being picked up in most aggregate measures of inflation.)

12. We judge this monetary outlook consistent with some further fall in inflation this year and some modest rise before the end of 1987. The main short term influence on changes in inflation stems from the combination of commodity price and exchange rate movements, shown in the changes in import prices in the table in paragraph 17.

Exchange rates

13. Sterling is currently some 3-6 per cent higher in relation to the second half of last year than we would have expected given the fall in oil prices, the interest differential and the fall in the dollar. We have allowed for a 5 per cent fall in the sterling index over the next year. This judgment takes account of the move by the current account towards a small deficit next year; the need in the longer run for the real exchange rate to adjust to the fall in oil production; and maintenance of something like the current interest rate differential, reflecting both higher UK inflation and higher real rates here.

14. The sterling index and the rate against the dollar might look as follows:

	Sterling index	£/$
1985 Q4	80	1.44
1986 Q4	74	1.52
1987 Q4	70	1.47

This is consistent with not much change in competitiveness: the gains expected as oil prices fell have been offset by a combination of a smaller fall in the exchange rate and higher UK inflation. Hence the UK is getting more of the benefit from the fall in oil prices on inflation; but because of the absence of competitiveness gains, less on output.

Balance of Payments

15. The current account surplus, now put at nearly £4 billion in 1985, looks set to fall away, perhaps into deficit next year. Not only was 1985 the peak year for oil, but it also saw an exceptionally strong performance in manufactures in both overseas and domestic markets, which seems not to be continuing. There should be some offsets, mainly in the form of higher invisible earnings.

The forecast shows – £1½ bn in 1987 compared with + £3bn in 1986.

Inflation

16. Most measures of (price) inflation in the UK will soon be in the region of 3 per cent; and similar figures are expected for much of 1987. Low rates of inflation make the difference between different measures more obvious. The RPI, in particular, because of its dependence on the mortgage rate, will show some very low figures this autumn: perhaps not much more than 2 per cent. Other measures of inflation will also show lower figures later this year, and low (but rising) figures in 1987.

Inflation rates, per cent

	Producer prices	GDP deflator	RPI	RPI less mortgage interest payments	World: Major 7 consumer inflation
1984 Q4	5.7	3.8	4.8	4.1	4.1
1985 Q4	5.9	7.3	5.5	5.2	3.6
1986 Q2	4.5	4.7	2.9	3.3	2.0
1986 Q4	3.3	2.1	2.3	3.1	0.9
1987 Q4	3.7	3.4	4.0	3.4	1.7

1986 Q2 figures are partly or wholly forecast.

17. The downward shift in UK inflation from about 5 per cent in the period 1983-85 to 3 per cent or so later this year reflects a good part of the world wide fall in inflation, which in turn results to a large extent from the fall in **real** commodity prices. The failure of inflation in the UK to fall as much as in other countries reflects both the fall in sterling and cost developments in the UK. The table below shows the large swings in import prices:

Influences on prices

	Import prices (total)	Unit labour costs (private sector)	Profitability (non-oil)
1985 Q4	- 5	+5.4	11.4
1986 Q4	+ 1	+4.6	11.7
1987 Q4	+ 6	+3.6	11.3

18. Faster UK inflation could arise from a sharper decline in sterling, or a more rapid recovery in commodity prices. Previous forecasts, however, have tended to understate the weakness in commodity prices, for a given level of world activity.

THE FISCAL PROSPECT

19. The fiscal prospect is the subject of a separate report by PSF. Our forecasts, assuming a PSBR set at 1.75% of GDP in 1987-88, compare with the Budget forecast as follows:

£billion

PSBR	1984-85	1985-86	1986-87	1987-88
Budget forecast/MTFS	10.2	6.8	7.1	7(2)
June forecast	10.2	5.9	7.5	7(2)
Financial Deficit				
June forecast	15	9	12	11

(fiscal adjustments in brackets)

20. As a measure of the fiscal position, the public sector financial deficit, which does not allow for privatisation proceeds nor for net lending by the public sector, shows more of a fall in 1985-86 and a larger rise in 1986-87. The low figure in 1985-86 reflected in particular high oil revenues, compared with 1986-87; and low coal strike costs, compared with 1984-85.

Changes since the Budget

21. Overall, the PSBR forecast for the current year **1986-87** is only a little higher from the Budget estimate of £7 billion. Within the total, the main changes are as follows:

(i) The forecast of the planning total is higher by £1 billion: we think that the £4.5 billion Reserve is likely to be overspent. (See table in paragraph 26.)

(ii) Oil revenues are £0.6 billion lower, mainly because of the firmer £/$ exchange rate and lower average $ oil prices, but non-oil revenues are higher, despite a lower forecast of the rise in money GDP, especially income tax and National Insurance Contributions because of the higher forecast wages bill. In total revenues are little changed in 1986-87.

22. The FSBR quoted an average error of £4 billion for the PSBR in 1986-87, based on the forecasting record of the last 10 years. With only a limited amount of extra information available, the record of June forecasts, on average, is a little better than Budget forecasts. In recent years, the June 1983 forecast correctly anticipated a sizeable overshoot; the June 1984 forecast failed to anticipate the overshoot because of a more extended coal strike than expected. The June 1985 forecast correctly anticipated little change in the PSBR from the Budget estimate.In forecasting the PSBR we make allowance for normal contingencies but not for major costs such as the coal strike.

23. For **1987-88,** the MTFS projections for public expenditure were on the basis of the PEWP planning total, despite earlier forecasts that it would be substantially exceeded. The MTFS also scaled down the revenue projections to keep the published fiscal adjustment close to our underlying forecast. It is not surprising, therefore, that the June forecast shows both expenditure and revenue substantially higher than in the MTFS. The main changes from the MTFS projections are as follows:

(i) The forecast of the planning total is higher by £4 billion: see below.

(ii) Tax revenues and NICs are forecast over £3 billion higher. A substantial reduction in non-oil corporation tax receipts (because of lower forecast profits in 1986) is more than offset by further large additions to income tax, NICs and expenditure taxes.

(iii) Other smaller changes, including a reduction of £0.2 billion in net debt interest payments.

Public expenditure planning totals

24. The forecast of public expenditure is explained in detail in the PSF report. It takes account of changes in the economic environment and of likely policy changes in the Survey, as assessed by the expenditure side of the Treasury. We forecast net overspends on the 1986 PEWP programmes in 1986-87 and 1987-88 of some £5.6 billion and £10.2 billion respectively, compared with Reserves of £4.5 billion and £6.25 billion. This assumes privatisation proceeds at the PEWP figure of £4.75 billion a year. Our forecast therefore suggests that the Reserves will be insufficient by about £1 billion and £4 billion (and much more in 1988-89).

25. Pressures on programmes, reflected in our forecast of substantial overspends, are greatest in the usual areas of social security (despite lower inflation) and local authority current expenditure. In addition, very large bids for local authority capital have been made, and overspend in this area remains high. Bids in cash-limited areas are numerous.

26. The broad picture is as follows:

	1986-87		1987-88	
			£billion	
1986 PEWP programmes	139.3		142.3	
Forecast overspends (including Survey bids)	5.7		10.3	
Of which:				
social security		1.4		1.4
local authority current		2.4		4.3
local authority capital		0.7		1.5
cash-limited expenditure		0.3		1.7
other demand-led		0.9		1.4
<u>Less</u>				
Privatisation proceeds	-4.75		-4.75	
Forecast planning total	140.2		147.8	
1986 PEWP planning total (programmes plus Reserve less privatisation proceeds)	139.1		143.9	
Net overspend	1.1		3.9	

27. If we exclude privatisation proceeds and coal strike effects from the planning total, the forecast shows the following pattern:

	1985-86	1986-87	1987-88
			per cent increases on a year earlier
Cash	5.0	7.1	5.3
GDP deflator	6.2	3.1	3.9
Cost terms	-1.2	+4.0	+1.4

The sharp slowdown in the rise in the GDP deflator because of lower oil prices has little effect on the cash figure for public expenditure in 1986-87: this contributes to the sharp rise in cost terms in 1986-87.

28. Public service pay is assumed to rise a little faster than private sector pay, including an additional £1.25 bn for teachers' pay over 4 years. That is substantially faster than the GDP deflator used to calculate cost terms figures: in 1987-88, over 7 per cent compared with 4 per cent. Consequently the volume figures - it is assumed that there is no squeeze on employment except for the target fall in civil service numbers - show no change in 1987-88, despite the forecast rise of over 2 per cent in cost terms.

General government current expenditure on goods and services

£billion

	1984-85	1985-86	1986-87	1987-88
Cash	71.3	73.7	80.1	85.2
Cost terms*	71.3	69.4	73.2	75.0
Volume*	71.3	70.0	72.3	72.6

* 1984-85 prices

SUMMARY TABLE AND COMPARISON WITH THE FSBR

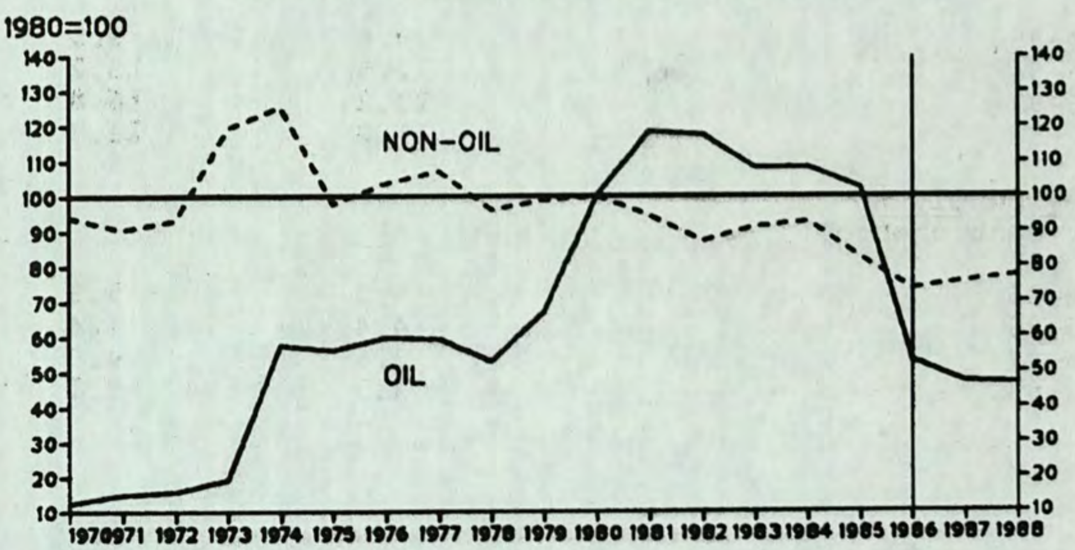
	FSBR/MTFS MARCH 1986	JUNE 1986 FORECAST
1. World GNP (major 7) (Per cent change on year earlier)		
1984	4.7	4.7
1985	2.7	2.8
1986	3.4	2.8
1987	3.9	3.6
2. Effective Exchange Rate (1975=100)		
1984	78.6	78.6
1985	78.2	78.2
1986	73.7	75.2
1987	71.5	71.7
3. Nominal GDP (market prices) (per cent change on year earlier)		
1984-85	6.9	7.0
1985-86	9.6	9.7
1986-87	6.8	5.8
1987-88	6.4	7.0
4. GDP Volume (per cent change on year earlier)		
1984	2.6	2.6
1985	3.3	3.3
1986	3.1	2.4
1987	2.4	3.1
5. RPI (per cent change on year earlier)		
1984 Q4	4.8	4.8
1985 Q4	5.5	5.5
1986 Q4	3.6	2.3
1987 Q4	3.3	4.0
6. Unemployment (UK s.a. excluding school leavers, millions)		
1984 Q4	3.10	3.06
1985 Q4	3.18	3.12
1986 Q4	3.13	3.26
1987 Q4	3.07	3.14

		FSBR/MTFS MARCH 1986	JUNE 1986 FORECAST
7.	**Current Balance** (£ billion)		
	1984	0.9	1.6
	1985	3.0	3.8
	1986	3.6	2.9
	1987	2.6	-1.4
8.	**PSBR - £ billion** (per cent of GDP in brackets)		
	1984-85	10.1(3.1)	10.2(3.1)
	1985-86	6.8(1.9)	5.9(1.6)
	1986-87	7.1(1.9)	7.5(2.0)
	1987-88	7.1(1.7)	7.1(1.7)
9.	**Fiscal Adjustment (annual not cumulative** (£billion)		
	1986-87	-	-
	1987-88	2	2
10.	**Interest Rates (Short-term)** (per cent)		
	1985 Q4	11.6	11.6
	1986 Q4	11.0	9.0
	1987 Q4	9.5	9.5
11.	**Money Supply £M3** (per cent change)		
	1984-85	9.6	9.5
	1985-86	12.9	13.2
	1986-87	13.2	16.8
	1987-88	11.2	13.7
12.	**Money Supply MO** (per cent change)		
	1984-85	5.5	5.5
	1985-86	4.4	4.4
	1986-87	2.6	4.0
	1987-88	3.9	5.1

THE WORLD ECONOMY

29. In the last couple of months oil prices have fluctuated between $10 and $15 per barrel, having fallen from an average in 1985 of $27 per barrel. In the short run a significant strengthening in oil prices depends primarily on how far OPEC succeeds in restricting supply. This may prove possible later in the year, helped by the seasonal strengthening of demand, but probably only to achieve a price of around $15 per barrel (rather than, say, $20 per barrel). For the purposes of this forecast, we have chosen to stick with the FSBR oil price assumption of $15 per barrel until the end of 1987. This compares with a futures price of West Texas Intermediate on 20 June of some $13 for the second half of 1986. Significantly lower prices, like $10 a barrel, may not be sustainable in the longer run. Prices of non-oil primary products are likely to remain weak as supplies continue to be abundant relative to demand, though we have allowed for a little recovery from current low levels.

COMMODITY PRICES
(IN RELATION TO PRICES OF MANUFACTURES)



30. The collapse in oil prices, coming on top of the continuing effect of the counter-inflationary macro economic policies pursued in recent years, has produced 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 low point for inflation could well be in the second half of 1986. But even if there is some pick up in the course of 1987, the inflation rate for 1987 as a whole should still be very low. The effects of the fall in oil prices on the general price level are in large part once-and-for-all, although there will be some continuing effect from, for instance, lower earnings growth. Inflation is likely to remain at negligible levels in Japan and Germany, but could well increase significantly in the U.S. in the later 1980s.

31. World output and trade have grown only slowly in recent months, turning out below the levels assumed in the FSBR forecast. In part, as in 1985 Q1, this can be attributed to extremely cold weather in Europe. There have been cutbacks in oil exploration and investment, and demand from outside the OECD has been weaker: there seems to have been little increase in imports by non-oil developing countries (because of depressed commodity prices and low capital inflows) and substantial cuts in OPEC imports (as first oil export volumes and then prices fell).

32. The increases in real incomes in oil-importing countries, produced by lower oil prices, have not been translated straight away into higher spending; the initial effects on world demand of the redistribution of income effected by lower oil prices may thus be negative. Higher saving ratios have, though, been accompanied by growth rates of money supply and liquidity in several countries in excess of the authorities' target ranges. Lower interest rates, strong equity and bond prices and other leading indicators also suggest stronger growth in the second half of 1986 and 1987.

World Economy

	Per cent changes on a year earlier			
	1984	1985	1986	1987
Major Seven countries[1]**:**				
Real GNP	4.7	2.8	2.8	3.6
Consumer prices	4.5	3.9	1.7	1.3
World trade, at constant prices				
Total imports	9.9	3.5	3.5	4.9
UK export markets[2]	8.4	5.0	3.0	4.6

[1]US, Japan, Germany, France, UK, Italy and Canada
[2]Manufactures

33. In the US short-term interest rates have fallen by 2 per cent in little more than a year and long rates by nearly 4 per cent, so that the yield curve is now virtually flat. These reductions reflect the slow down in inflation, which is mainly due to oil prices, and the better prospect of cuts in the Federal Budget deficit. Depreciation of the dollar, lower interest rates, high stock market prices and the boost given to real incomes by lower oil prices should all help strengthen growth in the US. There is however a wide range of views at present about prospects for the US economy, with our forecast for 1987 being toward the top end of the range of projections made by US forecasters.

Real GNP in US: per cent change on previous year

	WEP	"Blue Chip Consensus"		
		Average	Lowest decile	Highest decile
1986	2.6	2.8	2.3	3.5
1987	4.1	3.5	2.2	4.6

34. In Germany and Japan exports are forecast to grow much more slowly than in 1985 and could even fall following the appreciation of their currencies against the dollar. And domestic demand has been slow to strengthen in response to the real income gains produced by the improvement in their terms of trade. Real GNP in Japan is likely to grow in 1986 at a rate closer to 3 per cent than to the official forecast of 4 per cent. Output in Germany should also grow at about 3 per cent in 1986. Growth in both countries could pick up to about 3.5 per cent in 1987, but, given the relatively strong growth which we are forecasting for the US, these rates are insufficient to produce any marked reduction in the pattern of current account imbalances.

35. The forecast for the overall growth of world trade in 1986 shown in the table in paragraph 34 is very similar to that made by the OECD and the IMF in their latest forecasts, but is about one percentage point higher for 1987. The evidence is rather scanty at present, but developing countries (NODC) imports appear to have fallen in the second half of 1985 and early 1986, producing very low year on year growth between 1985 and 1986. OPEC members have also been reducing their imports and, unlike the NODCs, are forecast to continue to do so. The appreciation of the Yen produces faster growth of Japanese imports, but the usual difficulties for foreign manufacturers in penetrating the Japanese market are likely to limit the extent of this. The relatively high income elasticity of demand for imports in the US means that

its imports continue to grow, despite the depreciation of the dollar. The forecast assumes no major changes in levels of protection. On this picture of the world economy, the US current account deficit stops rising, but falls only a little. We have allowed for only moderate (3-4 per cent per year) further falls in the dollar: there is a clear risk that at some stage a more rapid depreciation of the dollar will lead to tighter US policies.

World import volumes, annual growth rates

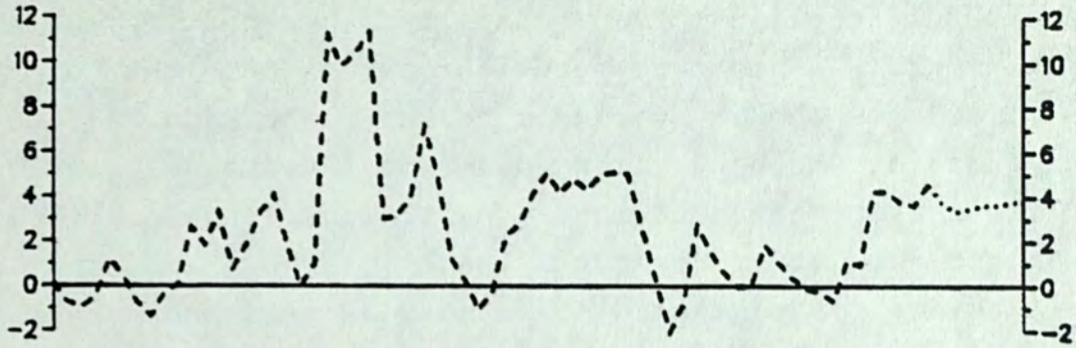
	US	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1985	18	7	31	6	17	21	100
Per cent changes on a year earlier							
1984	24	11	6	-10	8	10	9.9
1985	4	0	5	-14	3	7	3.5
1986	7(7)	5(9)	4(8)	-20(-16)	1(7)	5(6)	3.5(5.5)
1987	4	9	8	-20	6	4	4.9

* Germany, France, UK, Italy, Netherlands and Belgium
FSBR forecasts in brackets

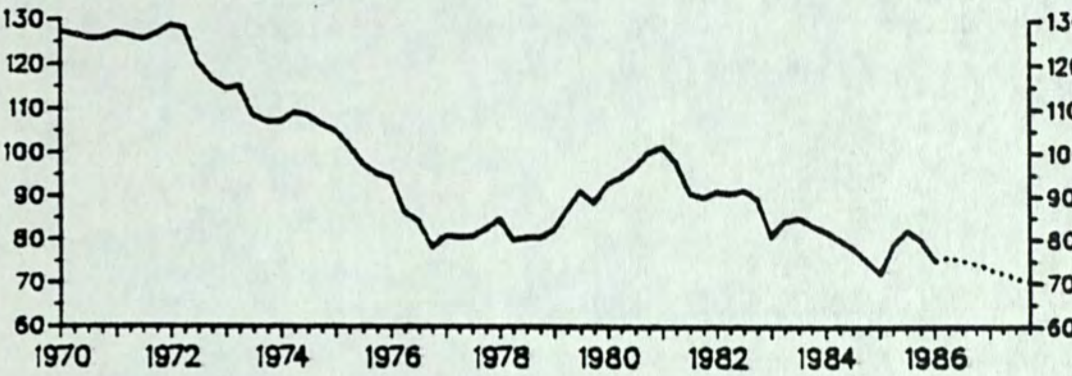
EXCHANGE RATES AND COMPETITIVENESS

36. Since the Budget the <u>sterling</u> index has been steady around 76, some 2-3 points above the level assumed in the FSBR forecast. Although sterling is some 6 per cent below its 1985 second half level it is still higher than we would have expected given the fall in oil prices. Our rules of thumb indicate that the fall in oil prices should have reduced sterling by over 10 per cent, other things equal. We suspect that the influence of oil prices may be a little less than we assumed and that more intangible factors, such as the market's favourable reaction to the Budget and the 1985-86 PSBR outturn, may have helped sterling.

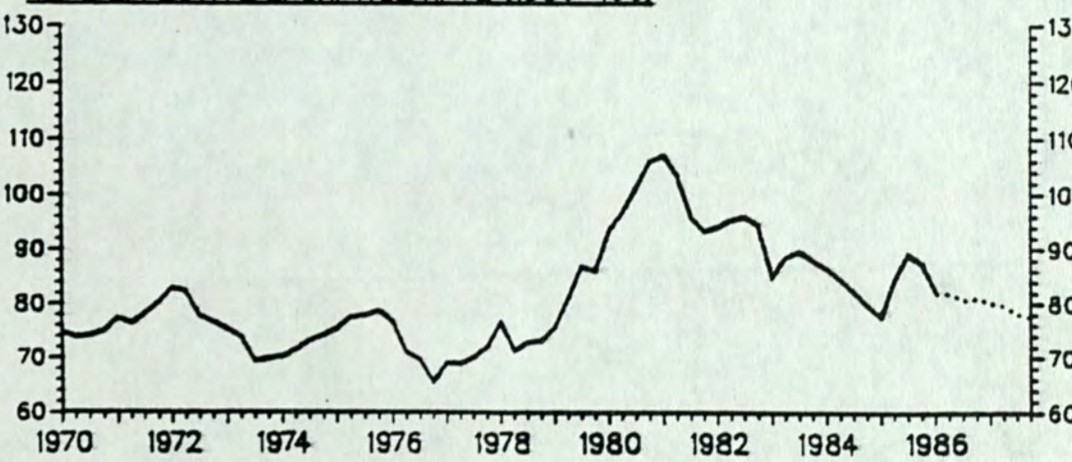
UNCOVERED DIFFERENTIAL AGAINST WORLD



EFFECTIVE RATE (1975=100)



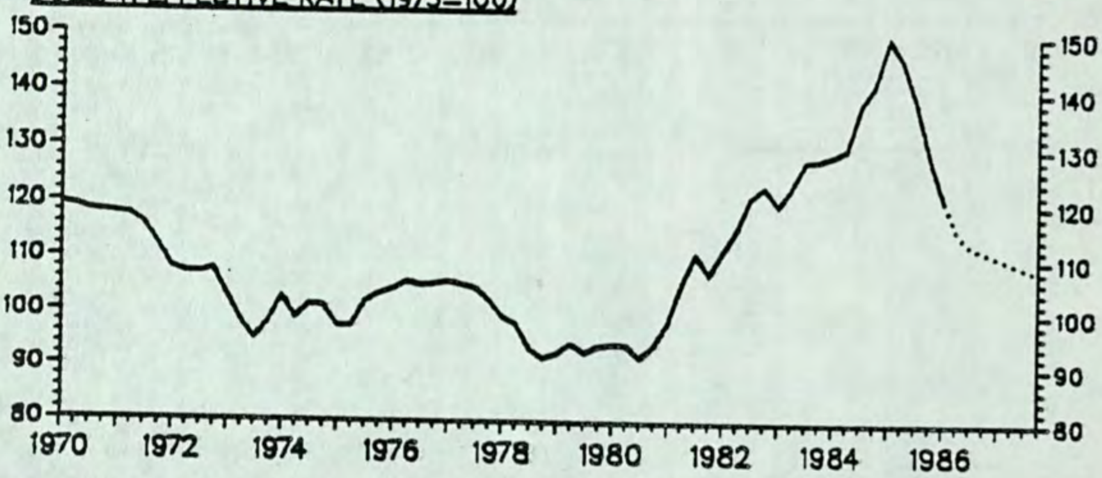
REAL EFFECTIVE EXCHANGE RATE (1980=100)



37. The market's implicit expectation, as reflected in forward rates, is for sterling to depreciate by 3 per cent a year over the next two years. In most respects our forecast of the UK economy is similar to those available to the market and there does not appear therefore to be a strong case for departing significantly from the market's expectation for sterling. The deterioration in the current account is however slightly larger in our forecast than outside forecasts and so we have assumed that sterling will be slightly below the level implied by forward rates.

	Dollar Index	Sterling Index	Dollar/ Sterling	DM/ Sterling
1984 Q4	142	75	1.22	3.72
1985 Q4	129	80	1.44	3.71
1986 Q4	112	74	1.52	3.27
1987 Q4	108	70	1.47	2.97

DOLLAR EFFECTIVE RATE (1975=100)



38. Domestic costs are still rising faster than those overseas as shown in the next chart. The table below shows that the relatively modest depreciation assumed leaves the average levels of price and cost **competitiveness** this year and next similar to the 1983-85 level. But the gains to competitiveness expected from a big fall in oil prices are not materialising: partly because the fall in the exchange rate has been less than expected, partly because the underlying inflation rate in the UK is above that in most other countries.

	Sterling Index (1975=100)	Manufacturing competitiveness: Relative actual unit labour costs (1980=100)	Relative export prices	Import price Competitiveness
1983-85 Average	80	86	90	97
1986	75	85	92	100
1987	72	83	90	98

TRADE AND THE BALANCE OF PAYMENTS

39. Helped by recent upward revisions to the invisible surplus, the current account is now estimated to have been in surplus by nearly £4 billion in 1985. A somewhat smaller surplus is forecast for 1986, a little less than anticipated in the FSBR forecast. But the underlying position, particularly for visible trade, is more fragile than these figures suggest and a move towards balance and, for the first time since 1979, perhaps deficit in 1987 is likely.

40. The current account position in 1985 was very strong, particularly after taking account of costs of the coal strike and the delay in EC refunds:

Current Account of the balance of payments

£billion

	Estimate Forecast (1)	Coal Strike (2)	EC refunds (3)	Estimate/ Forecast underlying (4)	of which NS Oil contribution (5)	Underlying less NS oil (6)
1984	1.6	2.8	-	4.4	3.9	0.5
1985	3.8	1.3	0.4	5.5	4.5	1.0
1986	2.9	-	-0.4	2.5	3.0	-0.5
1987	-1.4	-	-	-1.4	1.8	-3.2

(4) = (1)+(2)+(3)

(5) = net exports of oil less NS oil debits

(6) = (4)-(5)

41. Some deterioration in the current account is expected in both 1986 and 1987 because of:

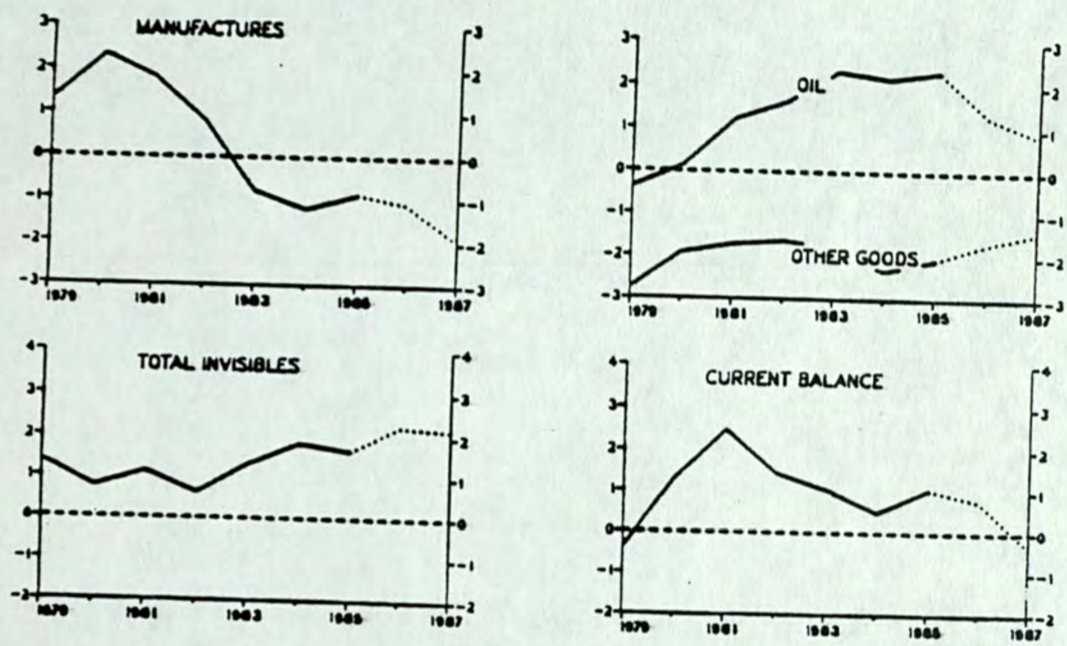
(i) The fall in the oil balance

(ii) The tendency of the UK to lose share (in volume terms) in domestic and overseas markets. In the past this has been compensated by a slower growth in UK domestic demand; but in this forecast domestic demand grows at much the same rate as in other countries. In addition the UK's export markets are comparatively weak because of falls in imports into OPEC and some other countries (especially South Africa and Australia)

(iii) The terms of trade (on goods other than oil) in the first five months of 1986 were 2.7 per cent higher than the 1985 average, but we have allowed for a 1-2 per cent fall in 1987, with a mild recovery in commodity prices.

42. The forecast of the various components of the current account are summarized in the next chart. 1985 shows up with a strong performance in manufactures in relation to the growth in markets.

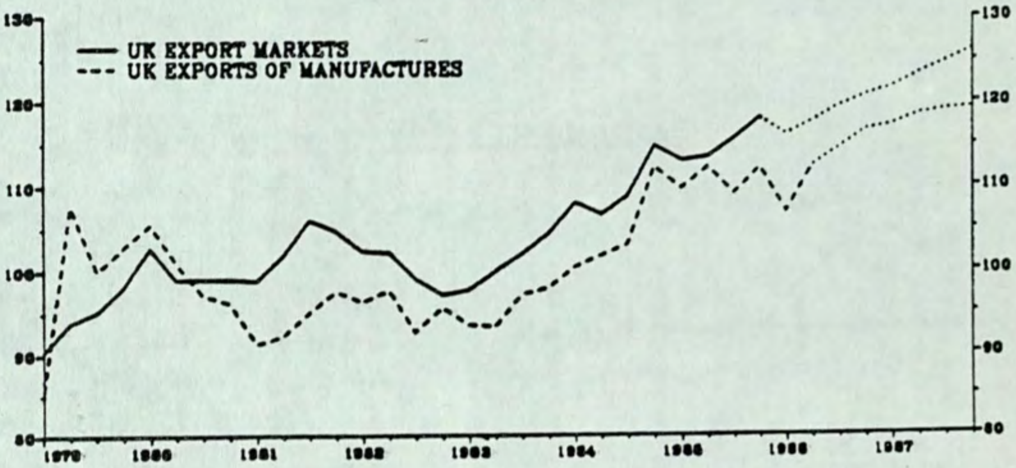
TRADE BALANCES AS SHARE OF GDP



Trade in manufactures

43. Both export and import volumes were lower in the first quarter of 1986 than anticipated in the Budget forecast. In the case of exports some of the explanation lies in weaker than expected growth of UK export markets. This forecast assumes both a sharp recovery in the second quarter and steady export growth from now on, but the level of manufactured exports in volume terms in 1986 could still be 4 per cent below the Budget forecast. Taking 1986 and 1987 together we expect the volume of exports, boosted from April 1986 by arms sales to Saudi Arabia, broadly to keep pace with the growth of our export markets, as shown in the next table and chart. Changes in relative prices and costs should have only a minor impact.

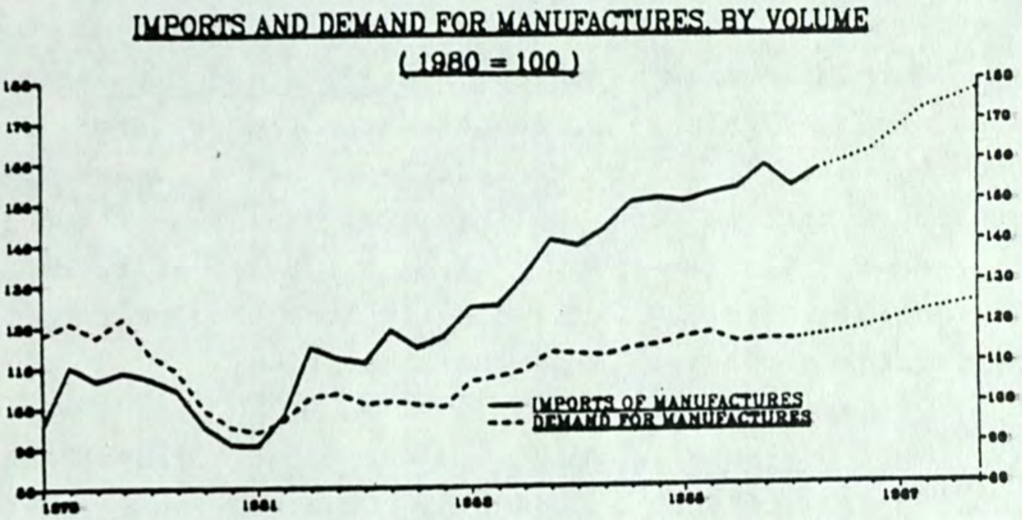
UK EXPORTS OF MANUFACTURES AND THEIR MARKETS, BY VOLUME
(1980 = 100)



Trade in manufactures: per cent change on previous year

	VOLUMES				TERMS OF TRADE
	Export markets	Exports	Domestic demand	Imports	
1982-85 Average	4.7	5.0	5.0	9.5	-0.1
1986	3.0	1.7	0.7	3.3	+2.2
1987	4.6	5.2	5.0	9.4	-1.8

44. The table above shows imports of manufactures growing nearly twice as fast as domestic demand, a long established trend of rising import penetration. Growth in exports is expected to be close to the growth in markets.



45. The terms of trade in manufactures improved sharply in the second half of last year, but with a falling exchange rate some deterioration is likely by next year. Together with adverse volume movements this contributes to a sharp rise in the deficit on manufactured trade in 1987.

Invisibles

46. There are signs of some weakening in the <u>services</u> account, after very strong growth to mid 1985. The loss of American

tourists on account of their concern about terrorism is currently forecast to amount to about 1 per cent of total service exports (£0.2 billion). More important is the worsening competitiveness of services and the sharp cutback in service imports by OPEC. The pick up in world activity, and some regaining of competitiveness (to which services seem sensitive) together with the fall in the exchange rate this year and the projected gentle decline should improve the balance but not before 1987. The deficit on transfers, unusually low this year because of the late receipt of the rebate on the UK's 1984 EC contribution, is likely to rise again next year.

47. Earnings from interest, profits and dividends (IPD) should rise strongly this year, despite a poor provisional first quarter figure, and again next year as the value of overseas assets continues to rise, and profitability remains strong. Oil IPD, depressed last year by BP's once-for-all write off of losses on its Sohio subsidiary, will benefit from the lower profits earned by foreign companies in the North Sea.

48. Net overseas assets are estimated to have been £87 billion (25 per cent of GDP) at end-1985 compared with £12 billion (6 per cent of GDP) in 1979. While the run of current account surpluses has made a major contribution to the build up of net assets, currency and asset price changes have been the dominant influence in recent years. This is also true of the forecast. Net assets are projected to rise by over £30 billion in 1986 and 1987 to over £120 billion (31 per cent of GDP) by end 1987. There have already been large positive revaluations in 1986 and the recent rise in the US stock market, which we assume will not be reversed, has been particularly important.

INFLATION

49. It was clear a year ago that the inflation rate was likely to fall substantially in 1986: in the forecast completed in June 1985, when RPI inflation was running at 7 per cent, we forecast that inflation would be down to 4 per cent during 1986. Developments over the last year have meant progressively more favourable prospects for inflation. The outlook has improved again since the Budget: world prices and world and UK interest rates have been weaker than expected while the sterling exchange rate has been stronger. As a result our forecast for the RPI for the remainder of this year and early 1987 has been revised down further. We now expect the RPI to be only 2.25 per cent higher in 1986Q4 than it was a year earlier.

50. The fall in inflation experienced in the UK has been matched and often surpassed in other industrial countries. And in other countries there are clear signs of the slowdown in prices being reflected in lower growth in average earnings. In none of the four largest countries should average earnings grow by as much as 4 per cent over the next year, while in the UK there is still no sign of a fall in the rate of increase of earnings.

Measures of Inflation in UK and abroad

Percent changes in:	**1985**	**1986**	**1987**
Consumer/Retail Prices			
UK	6.1	3.1	3.3
Other Major 6 Countries	3.7	1.6	1.1
Wholesale Output Prices			
UK	6.3	4.1	3.6
Other Major 6 Countries	1.7	-2.1	1.0
Average Earnings			
UK	7.8	7.7	7.3
Other Major 6 Countries	5.0	3.6	3.3

Producer and retail prices

51. The recent small monthly increases in **producer prices** have reflected both the fall in input costs over the last year and the downward pressure exerted by low inflation in competitor countries.

Manufactures
percent changes on a year earlier
(annual average)

	unit labour costs	cost of materials and fuels	total costs	domestic output prices	prices of imported manufactures
1984	2.6	8.7	4.9	5.6	7.3
1985	5.1	4.2	5.0	6.3	6.4
1986	6.3	- 10.4	0.2	4.1	2.8
1987	3.7	2.8	3.1	3.6	6.8

52.These low output price increases are also showing up in the sections of the RPI which they affect such as consumer durables, household goods, and clothing and footwear. CBI survey results confirm the prospect of little growth in producer output prices over the next few months.

53. **Nationalised Industry Prices** paid by households should now rise less this year in aggregate than we had assumed at the time of the Budget. The Budget forecast did not allow for the passing through of lower fuel costs to household consumers that is involved in the 3.5 per cent cut in electricity prices announced in early June. The forecast now also allows for a further reduction in electricity prices in the late autumn, as well as a small cut in gas prices soon after privatisation.

54. Food commodity prices have been weaker than expected. Even coffee prices, which were the one serious exception to the generally weak trend earlier in the year, have fallen back and the retail price of coffee may have peaked. Assuming normal harvests this year in the UK and abroad, growth in **retail food prices** is not likely to change much from the 3 per cent increase recorded over the last year.

53. The main changes to the Budget RPI forecast have been to **housing prices.** The April increase in Local Authority rates as recorded in the RPI was about 3 percentage points less than expected. But the biggest revision to the price forecast reflects the lower interest rates now projected. The Budget forecast had only a 1 point cut in mortgage rates during 1986 from the 12.75 per cent level of last winter; in fact mortgage rates have already come down by 1.75 points and a further cut of a point now seems possible by the end of the summer. This revision to the forecast is worth roughly 5 per cent off the housing index in 1986Q4, and about 0.75 per cent off the RPI.

54. On our assumption of a $15 a barrel oil price, the prospects for **petrol prices** are little changed from what was in the Budget forecast. From a level of 162 p per gallon recorded in May, the average retail petrol price has already started to rise, as it often does during the summer months. We expect it to average about 169 p in the fourth quarter of 1986.

55. The forecast for the main components of retail prices is given in the table below (FSBR forecast figures in brackets).

		per cent changes on a year earlier			
	Weights	**1985 Q4**	**1986 Q4**	**1987 Q2**	**1987 Q4**
Food Prices	19	3.2	3.1 (3)	3.1 (3.5)	2.0
Nationalised Industry prices	9	5.4	3.0 (4)	0.6 (3)	1.6
Housing Prices	14	9.3	1.2 (7.5)	2.3 (5)	9.3
Other Prices	58	5.3	2.2 (3)	3.4 (3.5)	3.6
of which:					
Petrol	5	1.6	-11.2 (-10.5)	7.7 (1)	6.8
All Items	100	5.5	2.3 (3.5)	3.0 (3.5)	4.0
All items excluding mortgage interest payments		5.2	3.1 (3.7)	3.4 (4.4)	3.4

56. The recent experience of rapid falls from month to month in the recorded annual inflation rate will soon be over. Retail prices rose by only 0.9 per cent between June 1985 and January 1986: this makes it difficult to achieve a substantial further decline in inflation in the second half of 1986. Nevertheless, although there may be months where the rate of inflation rises a little, some further net decline in the inflation is expected by the end of the year.

Forecast of monthly inflation figures
(per cent changes on a year earlier)

	RPI	**RPI excluding Mortgage Payments**
May	2.8	3.1
June	2.6	3.5
July	2.5	3.4
August	2.1	3.4
September	2.6	3.4
October	2.4	3.2
November	2.2	3.0
December	2.3	3.1

§ D Emp expect 2¾ %

Alternative Measures of Inflation

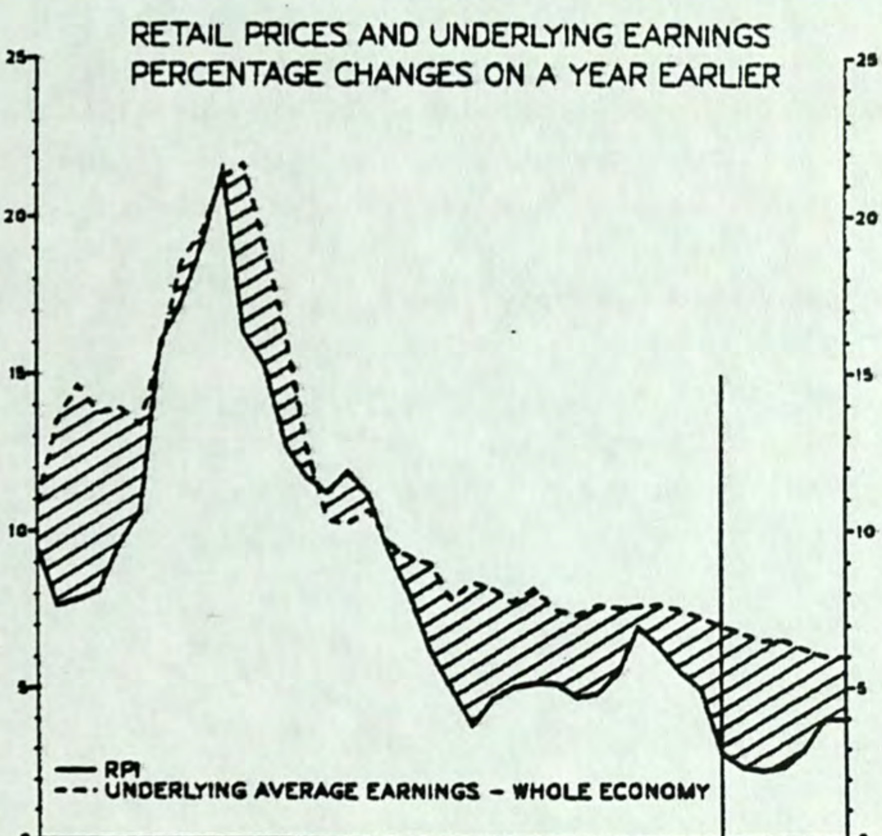
57. The tables above indicate the impact on the RPI of forecast changes in mortgage interest rates which means that the RPI will rise less than other price indices over the next year. The **GDP deflator,** which measures the price of UK "value added" is not, of course, directly affected by movements in interest rates. But it too is subject to temporary downward influences during 1986: because it is affected by movements in oil company profits, the collapse of oil prices since last year will show up for a while in a markedly lower rate of growth of this measure of inflation. The table below shows that we expect growth in the GDP deflator to be below the MTFS path in 1986-87, but to rise back to it in 1987-88.

GDP Deflator, per cent change on a year earlier

	1984-85	1985-86	1986-87	1987-88
MTFS	4.2	6.1	3.7	3.8
June forecast: total	4.3	6.2	3.1	3.9
total less oil	3.5	8.1	5.6	3.4

Pay

58. Pay settlements in the private sector may on average be marginally less over the current pay round as a whole than in 1984-85, but there is no sign yet of any significant response in settlements to the recent decline in price inflation. With an increase in settlements in public services since last year, it is only the fall in overtime working and subsequent loss of earnings in manufacturing industry that is keeping underlying earnings growth for the whole economy down to the now familiar level of 7.5 per cent. Real earnings growth over this pay round will be around 5 per cent, almost half of which may have been unanticipated given the forecasts current at the start of the round. Past experience suggests that this difference will have little effect on pay bargaining in the next round.



Factors Influencing private Sector Earnings, Pay Rounds

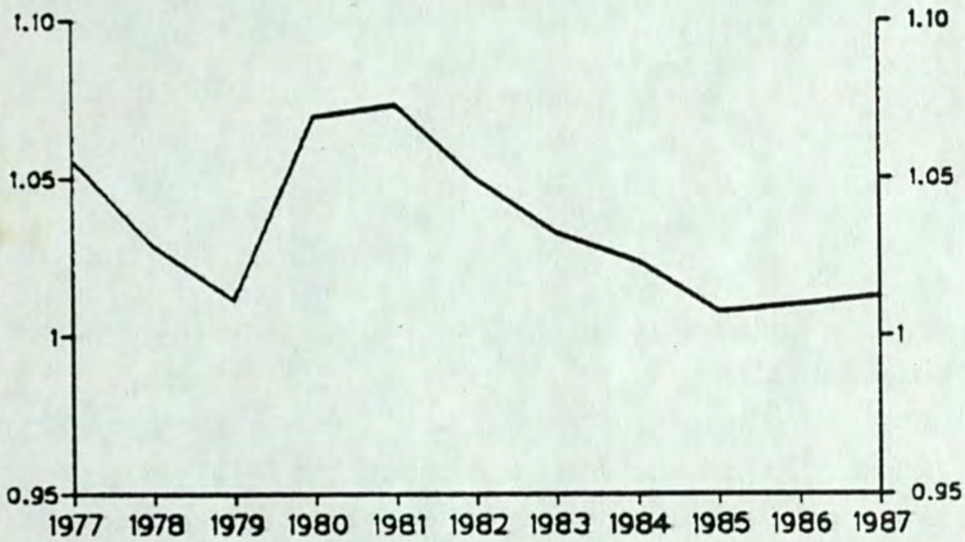
	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
RPI inflation	(figures in brackets are forecast)					
(i) At start of round, Q3.	8.0	4.6	4.7	6.3	(2.4)	(4.0)
(ii) Outcome on inflation, Q3	4.6	4.7	6.3	(2.4)	(4.0)	
Unemployment						
Level at start of round	11.0	11.9	12.3	12.5	(12.9)	(12.5)
Real take home pay						
(per cent, second half year on second half)	0.3	3.6	1.5	2.3	(5.4)	(3.5)
Profit Share per cent (Non North Sea ICCs)	8.8	10.0	11.8	12.7	(13.5)	(13.3)
Underlying Earnings Growth per cent change on a year earlier	8.3	7.8	8.5	7.8	(6.5)	(6)

59. The fall in non labour costs over the last year has meant that firms have been able to provide large real pay increases and still increase their profit margins. It will be a little less easy for them to be as generous over the next pay round. The large increase in living standards over the last year and the impact of recent inflation figures on expectations should also help to lower settlement rates at the start of the next pay round.

60. We think that earnings may grow by about 6.5 per cent over the pay round - this would imply settlements falling to around 4.5 per cent. While such an outcome would be below the range of settlements experienced since the 1960's, it would still imply a further growth of

real earnings (before tax) of some 3 per cent. With real incomes of both employees and employers rising strongly in 1986, the possible range of outcomes on pay is wide: either side would still be quite comfortable if earnings growth were 1 or 2 per cent higher or lower.

RELATIVE EARNINGS IN PUBLIC SERVICES
TO WHOLE ECONOMY EARNINGS (UNDERLYING)
(JAN 1980=1)



61. Pay in the public services fell relative to private sector earnings between 1981 and 1985. The chart suggests that on average the fall over this period was sufficient to offset the relative gains made by public sector employees in 1980.

62. Pressure to prevent further or reverse relative declines in the pay of various groups in the public sector has been evident over the last year, most notably in the protracted disruptive action taken by schoolteachers. For the forecast we have assumed that public sector employees other than school teachers on average achieve earnings increases in line with the private sector from now on: given the lower drift experienced in the public sector this will mean public sector settlements 1 point or so higher than settlements in the private sector. Teachers are forecast to do somewhat better than this.

COMPANY INCOME AND SPENDING

65. In spite of the slowdown in output growth and higher growth in unit labour costs over the last year, the financial position of non-oil companies remains very healthy: about half the fall in oil companies' share in national income is reflected in an increase in the share of non-oil companies.

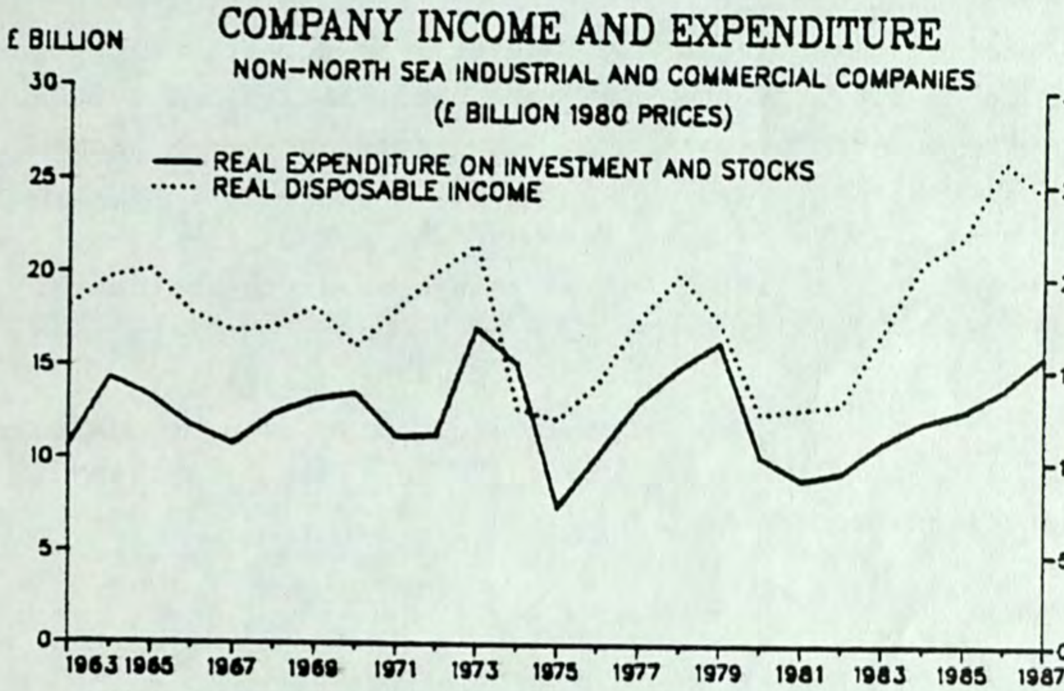
Industrial and Commercial Companies'

	Profits As a Share of Total Income*		Rate of return on assets, non-North Sea*
	Oil	Non-oil	
1973-1983 average	2.5	10.3	5.3
1984	6.9	11.1	6.5
1985	6.0	12.4	8.1
1986	2.7	13.6	9.1(9.6)
1987	2.3	12.9	8.6(9.3)

* Net of stock appreciation; adjusted for privatisation
( ) FSBR forecast

66. The margin of uncertainty about these figures as represented by the balancing item in the ICCs accounts is now smaller than it was. Following successive revisions, the £10 billion "black hole" for 1984 that we were faced with a year ago is now a somewhat more manageable £3 billion; however, the current estimate of the balancing item of 1985 is over £6 billion. This makes for a large gap between the sizeable financial surpluses of companies and their overall borrowing needs.

67. The forecast for non-oil company spending is relatively little changed from the Budget forecast, and remains rather subdued in total relative to company income. Although companies increased their dividend payments by nearly 30 per cent in 1985, they seem likely to continue to run large financial surpluses over this year and next.



NOTES: FIGURES ARE APPROXIMATE, ADJUSTED FOR ESTIMATED EFFECTS OF PRIVATISATION AND DO NOT TAKE ACCOUNT OF CERTAIN TRANSACTIONS BETWEEN NORTH SEA OIL COMPANIES AND OTHER INDUSTRIAL AND COMMERCIAL COMPANIES

Business Investment

68. As anticipated, business investment picked up strongly in the first quarter ahead of the phasing out of capital allowances. However, the increase in investment in non-manufacturing industry over the fourth quarter (3 per cent) was lower than in the corresponding period last year (12 per cent), and also lower than we had forecast. (The rise in manufacturing investment - at 6 per cent - was much as

forecast). The extent to which investment would be brought forward into the first quarter was always a matter of considerable uncertainty, and the results for the first quarter do not mean that the Budget forecast for the year as a whole was too high.

69. The DTI Intentions Survey published at the beginning of June shows an improvement in prospects for investment this year (particularly in manufacturing industry) as compared with the previous survey, and confirms the view on non-oil business investment that we took in the Budget forecast. In the forecast we assume that the latest Survey is right about 1986. For 1987 the Survey suggests a similar growth in investment to that expected for 1986: we think investment may do a little better than the Survey indicates.

Fixed Investment

Percentage change on previous year

	1985	**1986**	**1987**
Manufacturing* (£6.4 billion in 1984)			
DTI Survey	6.5	3	2
HMT	6.5	3	3
Non-oil, non-manufacturing** (£14.5 billion in 1984)			
DTI Survey	6	4	5
HMT Forecast	6	4	6

* Including leased assets

** Adjusted for privatisation and excluding assets leased to manufacturers.

70. Manufacturing investment remains low in relation to output: between 1979 and 1985 the ratio of investment (including leased assets) to output in manufacturing industry fell by 10-15 per cent. This fall does not seem to reflect compositional changes in manufacturing output to any significant extent. Although there have been major compositional changes in manufacturing output since the 1970's, and although some of these changes (for example, the decline in the importance of the steel industry and the rise in importance of

electrical engineering) are in the direction of a less capital intensive mix, these changes are offset by the increased weight in total output of chemicals, which is an exceptionally capital intensive section of manufacturing industry.

71. The relatively low rate of manufacturing investment seems to reflect business caution following the severe recession of 1980 and financial factors such as high interest rates: further rises in investment over the next few years seem likely as long as there is not a prolonged period of weakness in the demand faced by UK manufacturing industry. Although the number of firms reporting a lower than normal rate of capacity utilisation has risen since last summer, it remains well below the numbers recorded in the period before mid 1984. Indeed, with the gross capital stock in manufacturing (according to the CSO's measure of it) rising by less than 1 per cent a year, a return to growth in manufacturing output at a rate of 2 to 3 per cent a year would at some stage require a step up in the level of investment - though there must still be considerable scope for making productivity improvements without expanding the capital stock.

72. The table below summarises the forecast for fixed investment, with the FSBR forecast shown in brackets. Figures for 1987 were not published in the FSBR.

	Fixed Investment, £billion,1985	**per cent change on year earlier**		
		1985	**1986**	**1987**
Business Investment	29.9	3 (2)	3 (5)	3(1)
Residential Investment	9.4	-1 (0)	8 (5)	3(3)
General Government Investment	6.6	-5 (-5)	4 (2)	6(-2)
Total Fixed Investment	45.9	1 (1)	4 (5)	3(1)

Stockbuilding

73. Stockbuilding has remained subdued throughout the recovery. Of the £0.7 billion real increase in stocks in 1985, £0.5 billion was accounted for by the stocks of the Intervention Board for Agricultural

Produce. Energy stocks were little changed over the year, following a £0.1 billion rise in oil stocks in the last quarter of 1985. There was a £0.5 billion fall in manufacturers' stocks in 1985 as a whole but distributors stocks showed a small increase.

74. Published figures show that the decline in manufacturers' stocks continued into the first quarter of 1986. Nevertheless the fall recorded in output in the first quarter means that there was a (presumably undesired) rise in manufacturing stock output ratios. We expect that this will be corrected by further destocking in manufacturing during the remainder of 1986; at the same time the surprisingly large rise in wholesalers' stocks in the first quarter is also likely to be run off over the rest of the year. With little growth in stock prices this year, the real cost of holding stocks is currently at an exceptionally high level and the decline in stock output ratios of the last few years is likely to continue throughout this year. In total we expect the evolution of stockbuilding to make a somewhat more negative contribution to GDP growth in 1986 than we thought at the time of the Budget.

75. Later this year and into 1987 the cost of holding stocks is forecast to fall. Stock output ratios may start to stabilise, and higher stockbuilding may make a perceptible contribution to GDP growth in 1987.

PERSONAL INCOME AND SPENDING

<u>Consumers' expenditure</u>

76. A year ago we forecast that growth in consumers' expenditure would rise from 1.6 per cent in 1984, to 2.1 per cent in 1985, and 3.9 per cent in 1986. It is now clear that the acceleration in consumer spending occurred in the first half of 1985, rather sooner than forecast, with a 3 per cent increase in spending between the first and third quarters of last year. Consumers' expenditure in the first quarter of 1986 is estimated to have been 4.7 per cent higher than a year earlier.

77. As far as we can tell (the data on personal income is quite likely to be revised) the rise in consumers' expenditure during 1985 exceeded the rise in personal disposable income: ie there was a fall in the saving ratio. However, as inflation fell away at the beginning of 1986 the growth in income exceeded the continuing growth in consumers' spending and the saving ratio returned to around its level of early 1985.

78. At the time of the Budget, we expected growth in real personal disposable income of around 5 per cent in 1986, and growth in consumers spending of around 4 per cent. This remains our forecast for 1986. It allows for a rise in the saving ratio of over half a point between 1985 and 1986: such a rise is normal in the early stages of a period of exceptionally fast growth in income.

79. The improved inflation prospect and the limited adjustment of pay settlements to lower inflation means further strong growth in real personal disposable income in 1987. With spending still adjusting to the rapid income growth and falling interest rates and inflation of 1986, the saving ratio is expected to fall during 1987 to give a rise in consumer spending of around 4.6 per cent against income growth of 3.6 per cent. (The forecast allows for a £2 billion reduction in income taxes in the 1987 Budget, little changed from the FSBR projection.)

The Housing Market

80. The strength of house prices and housing starts over the last year is one of the more surprising features of recent economic developments in the UK. When mortgage rates rose sharply in the early months of 1985 housing starts appeared to be on a downward trend and building trade forecasts for 1985 were pessimistic. But 1985 saw buoyant demand and prices in the more prosperous parts of the country, and private housing starts rose during the year. So far in 1986 the strong growth in personal incomes, the easy availability of mortgages and more recently falling interest rates, have led to a quickening of house price rises over much of the UK. The amount of mortgage finance has been rising strongly: see table below. Although some of the extra lending will have been used, in effect, to finance goods other than

housing (and we take account of that in our consumption forecast), and to finance the purchase of financial assets, the fact that this credit is made available in the first place through the housing market is a factor in the rise of house prices.

Net Mortgage Advances (£ billion)

(by building societies, banks, and other lenders)

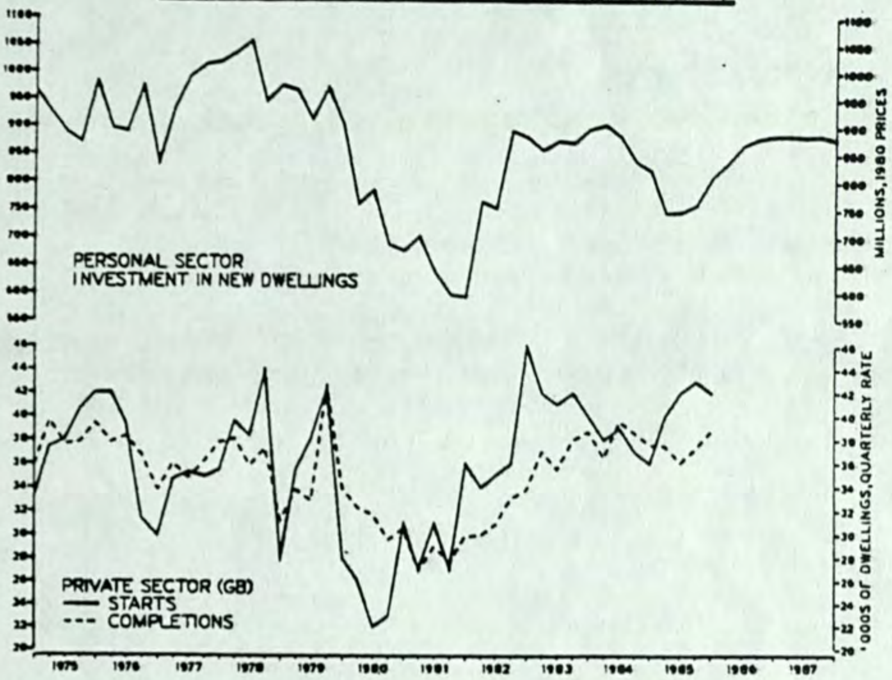
		In real terms (1984 prices)	
	Current prices	Deflated by new house prices	Deflated by the CED
1984	16.9	16.9	16.9
1985	18.1	16.8	17.2
1986	21.6	18.0	19.7
1987	25.5	19.2	22.5

81. We identify two elements of private housing investment: investment in new dwellings, and improvements to existing dwellings. The latter category fell sharply after the first half of 1984 following the extension of VAT and changes to the system of local authority improvement grants: in the first half of 1985 spending on improvements was 6 per cent lower than in the first half of 1984. But this spending picked up again during 1985 and is likely to reflect the fast growth in personal income over the forecast period.

82. Investment in new dwellings was at a low level in 1985: for the year as a whole it was 13 per cent lower than in the previous year. This low level of investment (in effect low sales of new houses) reflected in part a 3 per cent decline in private housing completions during 1985, which in turn was the result of a fall in housing starts the previous year. Moreover with stocks of uncompleted but unsold dwellings having been run down in the previous two years there seems to have been less scope for sales out of stock in 1985.

83. The rise in starts during 1985 should be reflected in higher completions and higher investment in dwellings this year and in early 1987.

HOUSE BUILDING AND INVESTMENT



84. The recent acceleration of house prices will have helped to increase the profitability of housebuilding. It is not yet possible to detect any further upward movement in housing starts over the levels of late 1985. Whether such an increase occurs later on this year will depend in large part on the elasticity of supply of the inputs used by housebuilders. Previous house booms have been associated with surges in the price of land and big rises in wages paid in the construction industry, which have quickly eroded the effect of higher house prices on builders' margins. There is certainly no sign of earnings in construction picking up (and given the generally depressed state of the construction industry we would not expect shortages of labour to be a problem.) The evidence on land prices so far is more mixed. Land prices have been rising by around 20 per cent a year on average over the last 3 years or so. There may have been some acceleration in land prices during 1985, but its extent is not clear.

85. For this forecast we have assumed that private housing starts do not pick up much further from current levels. The pick up in completions may do something to help moderate the rise in house prices; but house price inflation is expected to remain in double figures throughout 1986 and 1987: in total new house prices may rise by about 25 per cent over the two years as a whole.

Personal sector: summary

86. The table below summarises the forecast for personal income and spending.

	Personal income and spending (per cent changes on a year earlier)				Persons' net acquisition of financial assets
	RPDI	Consumers' expenditure	Investment in new dwellings	Total housing investment	(£bn)
1984	2.5	1.9	1.1	2.1	11.8
1985	2.5	2.8	-12.7	-2.5	10.9
1986	4.6	3.9	-10.5	10.2	13.3
1987	3.6	4.6	4.2	4.2	10.8

DEMAND AND ACTIVITY

87. The UK economy has shown sluggish growth for a year now. According to figures published by the CSO on 20 June, after adjustment for the recovery from the coal strike GDP rose by only about 1.5 per cent in the year to 1986Q1. There was a rise of about 0.7 per cent in GDP between the fourth quarter of 1985 and the first quarter of 1986; half of this rise was attributable to higher oil output.

Indices of GDP, 1980 = 100

	Average estimate of GDP	Strike adjusted GDP	Strike adjusted Non-oil GDP
1985 Q1	108.7	110.0	108.1
Q2	110.5	110.8	109.2
Q3	110.1	110.1	108.5
Q4	110.6	110.6	109.0
1986 Q1	111.3	111.3	109.4

88. This sluggish period follows three years up to the first quarter of 1985 when growth was in the range 3-3.5 per cent: during 1984 strike adjusted growth in GDP was at the top of this range. The performance of manufactured exports played an important part both in the recent weakness of demand overall and in its earlier strength; exports of manufactured goods rose by 9.2 per cent in the year to 1985Q1, and fell by 2.5 per cent over the most recent year.

89. Growth in domestic demand has not changed much overall in the last year, athough there has been a major change in its composition, with consumers' expenditure buoyant and most categories of fixed investment at least temporarily depressed. The table below sets out the path of domestic demand (at constant prices).

	Per cent changes on a year earlier				
	1983	1984	1985	1986	1987
Personal consumption	3.9	1.9	2.8	3.9	4.6
Public consumption	1.8	1.4	0.3	1.6	0.3
Total investment	5.2	8.1	0.8	4.3	3.3
Change in stockbuilding (as per cent of level of GDP)	0.9	- 0.4	0.4	- 0.2	0.7
Total domestic demand	4.5	2.5	2.2	3.2	4.1
GDP	3.4	2.6	3.3	2.4	3.1

Within domestic demand, the demand for manufactures is usually a lot more cyclical than the total and seems to have been relatively weak early this year: an acceleration is expected later this year and in 1987, bringing with it faster growth in imports.

90. **North Sea output** was at much the same level in the first quarter of 1986 as it was a year earlier. 1986 is expected to mark the peak level of production; the start of the decline in North Sea output may take around 0.6 of a point off GDP growth next year.

91. **Manufacturing output** was about 0.7 per cent lower than a year earlier in the first quarter of 1986: the fall in manufactured exports has clearly been the main influence. The fall in output has not occurred across the whole range of manufacturing industry. Most of the fall has been accounted for by electrical engineering, which had shown exceptionally strong growth during 1983 and 1984: the electrical engineering industry appears to have been depressed world wide since 1985, and UK electrical exports have fallen sharply over the last year. As world trade and exports recover during the rest of this year, manufacturing output should also start to grow again, and growth in activity overall should pick up.

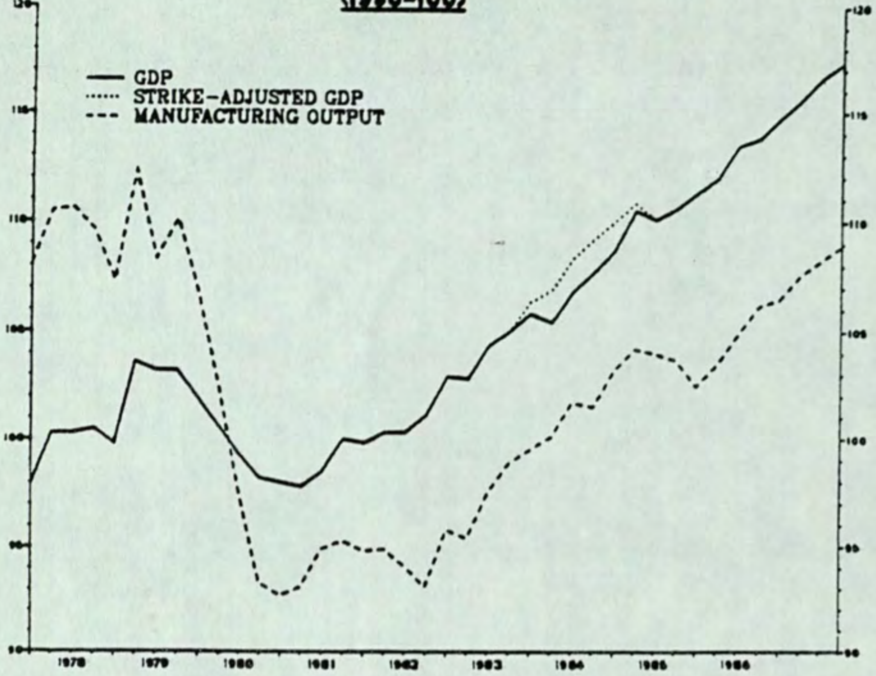
92. The table below shows the path of GDP before and after allowing for the coal strike. It also shows the path of manufacturing output.

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

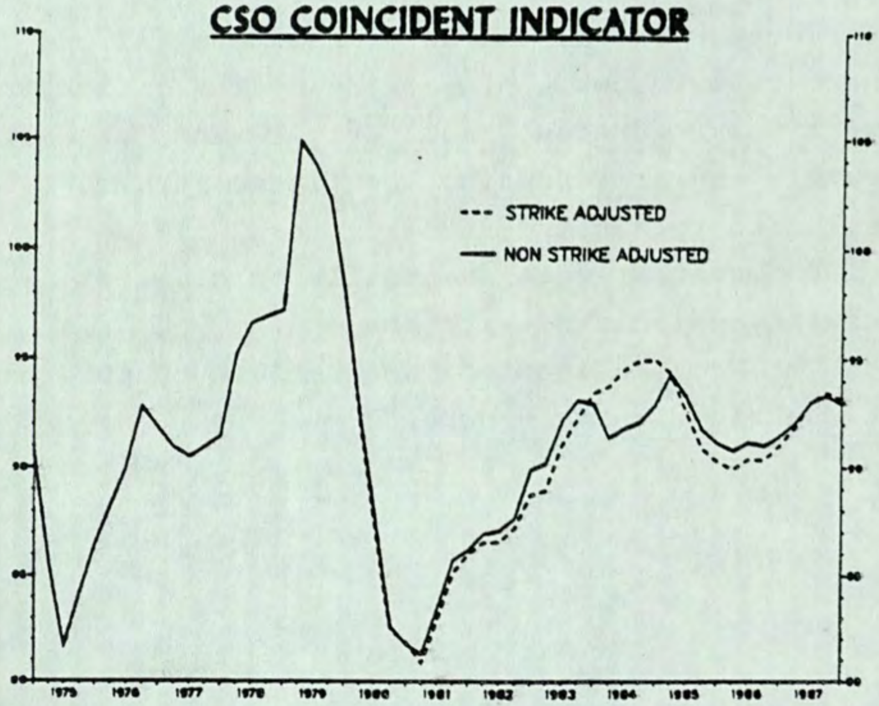
	1983	1984	1985	1986	1987
GDP Average Measure	103.7	106.4	110.0	112.6	116.1
	(3.4)	(2.6)	(3.3)	(2.4)	(3.1)
Contribution of North Sea production to GDP changes	0.5	0.3	- 0.1	0.1	- 0.6
Effects of coal strike	-	- 1.3	0.9	0.4	-
GDP less contribution of oil and coal strike	2.9	3.6	2.5	1.9	3.7
Manufacturing output	2.8	3.9	3.1	0.5	3.4

93. The CSO's coincident cyclical indicator has been falling since early 1985. The chart below shows a projection of the indicator that the CSO have made using our forecast for output and expenditure. Although the indicator may rise during the latter part of 1986 and 1987, it is not forecast to regain the level of early 1985. The peak at the beginning of 1985 may therefore eventually be classified as the start of a mild downswing, coinciding with the ending of roughly 10 years during which the expansion of North Sea output made a significant positive contribution to growth.

GDP AND MANUFACTURING OUTPUT
(1980=100)



CSO COINCIDENT INDICATOR



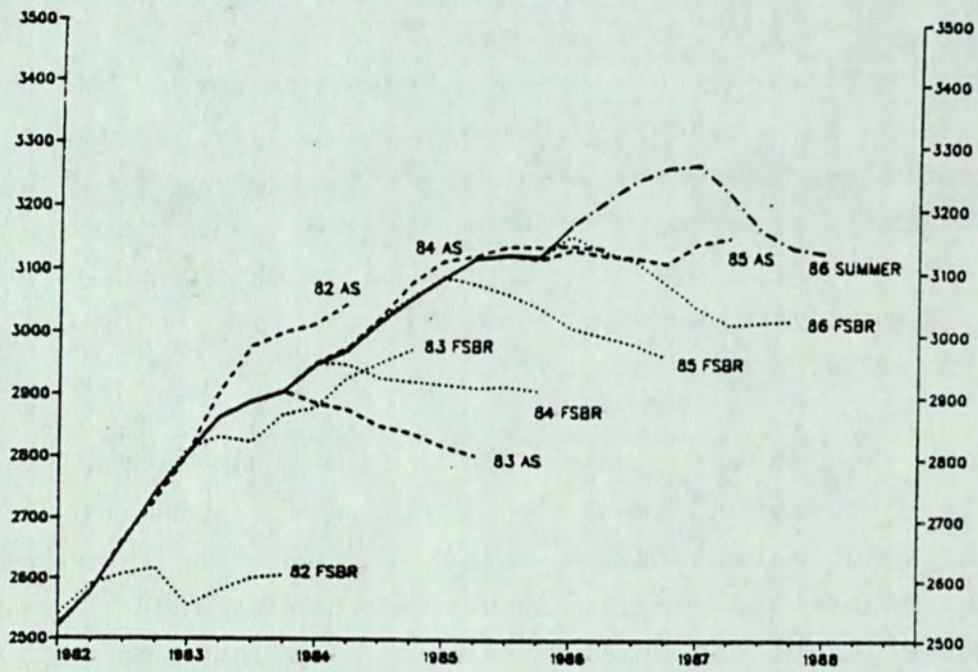
PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

94. There have been some substantial changes to our forecast for employment and unemployment since the Budget. The main results of the 1985 Labour Force Survey were published in April: recent employment figures were revised upwards in the light of these results, as we had suggested in January might happen. Further revisions are expected when the 1984 Census of Employment is published later this year.

95. At the time of the Budget we knew of three bad unemployment figures (for the months December to February) following the run of more encouraging figures between May and November of last year. We have now got three more months figures which show a substantial further rise in unemployment. In the three months to May, as in the previous three months, the underlying rise in unemployment was probably over 20,000 a month.

96. With the downward revisions to the data for manufacturing output in the second half of last year, and a fall in exports of manufactures and manufacturing output in the first quarter of this year, we understand a little better than we did the reason for the sudden worsening of the unemployment trend at the end of 1985. The underlying growth in the economy slowed down from over 3 per cent in the year to early 1985 to under 1.5 per cent in the year to early 1986, with the slowdown particularly marked in manufacturing (from almost 4 per cent growth to a fall of almost 1 per cent). It is not at all surprising in retrospect that this turnround in output led to a deterioration in the unemployment trend. It is, however, disappointing that the record of downward bias in our unemployment forecasts (see chart) should, so quickly, be confirmed again in our most recent forecast.

COMPARISON OF UK ADULT UNEMPLOYMENT FORECASTS
(000's, SEASONALLY ADJUSTED - ADJUSTED FOR CLASSIFICATION CHANGES)



97. In the early eighties our forecasts for unemployment were too low primarily because productivity growth exceeded expectations, and employment fell more than expected. Between 1983 and 1985 employment growth exceeded our forecasts, but growth in working population exceeded the forecasts even more. Our most recent forecasting error is probably mainly associated with manufacturing output turning out lower than expected.

98. The upward revisions to the employment figures in the light of the LFS, and the lower estimates now being made for manufacturing output last year mean that recent productivity growth in manufacturing now looks lower than we previously thought. Following four years in which output per man grew by 5.4 per cent a year on average, it grew by only 2.8 per cent in 1985. For the whole economy excluding the oil sector and the effects of the coal strike, productivity grew at a rate of around 1.5 per cent in 1985 compared with an average of around 2.5 per cent between 1980 and 1984. Such a slowdown in productivity is quite normal when output growth weakens, and does not in itself lead us to change our view of medium term trends in productivity: our current estimates of these are shown below.

99. Variations in the trend in productivity in manufacturing reflect changes in relative factor costs over a period of years: these are currently tending to push down manufacturing productivity growth, as is the state of the cycle. Productivity growth in non-manufacturing industry over this year and next should reflect major improvements in some nationalised industries (particularly in British Coal, but also in British Rail and the Post Office). On the other hand some selective employment measures, particularly the expansion of the Community Programme, tend to reduce output per man, as does the continuing trend towards part-time employment.

Productivity Growth, per cent per annum

	Manufacturing		**Non-manufacturing**		
	Trend	**Actual**	**Trend per full-time Worker**	**Trend per Head**	**Actual**
1973-79	1.5	0.7	1.4	0.9	0.6
1979-85	3.0	3.4	1.4	0.6	0.9
1985-87	2.4	2.6	2.5	1.7	1.5

The trends in this table discount purely cyclical effects.

100. The results of the 1985 LFS indicate that the labour supply grew by just over 200,000 between mid 1984 and mid 1985, compared with a rise of over 500,000 in the previous year. The growth of the labour force would have been lower still had it not been for an unexpectedly large growth in the population of working age. As of mid 1985 the population was 77,000 higher than had been forecast by OPCS a year ago: the error is attributable to emigration having been much lower than expected (immigration was much as expected). The working population (ie the employed labour force plus unemployed claimants) rose by about 500,000 between mid 1984 and mid 1985. The difference between this figure and the growth in labour supply over the same period reflects the difference between the survey based estimate of unemployment (which fell between mid 1984 and mid 1985) and the claimant count (which continued to rise).

Labour Force Estimate of Unemployment and the Claimant Count

(millions)

	Spring 1983	Spring 1984	Spring 1985
(1) Labour Force estimate of unemployed persons seeking work (on basis of one week period)	2.91	2.90	2.81
(2) of which: not claiming benefits	0.76	0.87	0.76
(3) Claimants not "unemployed"	0.84	0.94	1.08
of which:			
not looking for work	0.67	0.74	0.88
in employment	0.17	0.2	0.2
Claimant count (= 1-2+3)	2.99(2.9)*	2.98	3.13

* Figure in brackets adjusts Spring 1983 figure for the discontinuity caused by the removal of some older men from the Claimant Count following the 1983 Budget.

101. The table above helps to explain why the slower growth in the labour supply noted in the previous paragraph had little beneficial impact on the trend in unemployment. A large proportion of new jobs continued to be taken by women not claiming unemployment benefit. In the more recent period many of these women getting jobs were already classified as being in the labour supply (ie they had previously been looking for work although they were not claiming benefit). The rise in part-time jobs for women thus helped to reduce the numbers of non claimant unemployed (row (2) in the above table), with a correspondingly lower
effect on the number of claimant unemployed.

102. Department of Employment have not yet revised the labour supply projections that they published last July. OPCS have overestimated emigration and hence underestimated growth in working population for the last two years. The recent change in the trend in (net) emigration may well persist (to the extent that it is caused by such factors as the reduced attractions of South Africa). We have therefore assumed labour force growth above the Department of Employment's figures.

Projections of Labour Supply Growth

Mid Years	(GB) Employment Gazette July 1985	(UK) 000's Treasury Forecast
1984 to 1985	228	209
1985 to 1986	179	224
1986 to 1987	160	197
1987 to 1988	103	130

103. Even after the bad figures of the last six months, the increase in adult unemployment between Q2 1985 and Q2 1986 will have been lower than over the previous year. But we estimate that this improvement is more than accounted for by the impact of employment measures, and the restructuring of national insurance contributions. "Underlying" unemployment grew more over the last year than over the previous year, as employment growth slowed down. Over the next year a recovery of employment growth (to the rates of 3-400,000 a year experienced in 1983 and 1984) as the economy picks up again, and a bigger impact of employment measures, means improved prospects for unemployment. GDP growth of 3 per cent in 1987 (3.5 per cent excluding oil production), together with the forecast slower growth in labour supply, could be sufficient for unemployment to start falling.

Adult unemployment, 000's, changes

	Underlying Unemployment	Selective Employment Measures	Restructuring of NICs	Unemployment
1983Q2 to 1985Q2*	+166	-39	0	+127
1985Q2 to 1986Q2	+187	-88	-10	+89
1986Q2 to 1987Q2	+160	-117	-28	+15
1987Q2 to 1988Q2	-111	-16	-14	-141

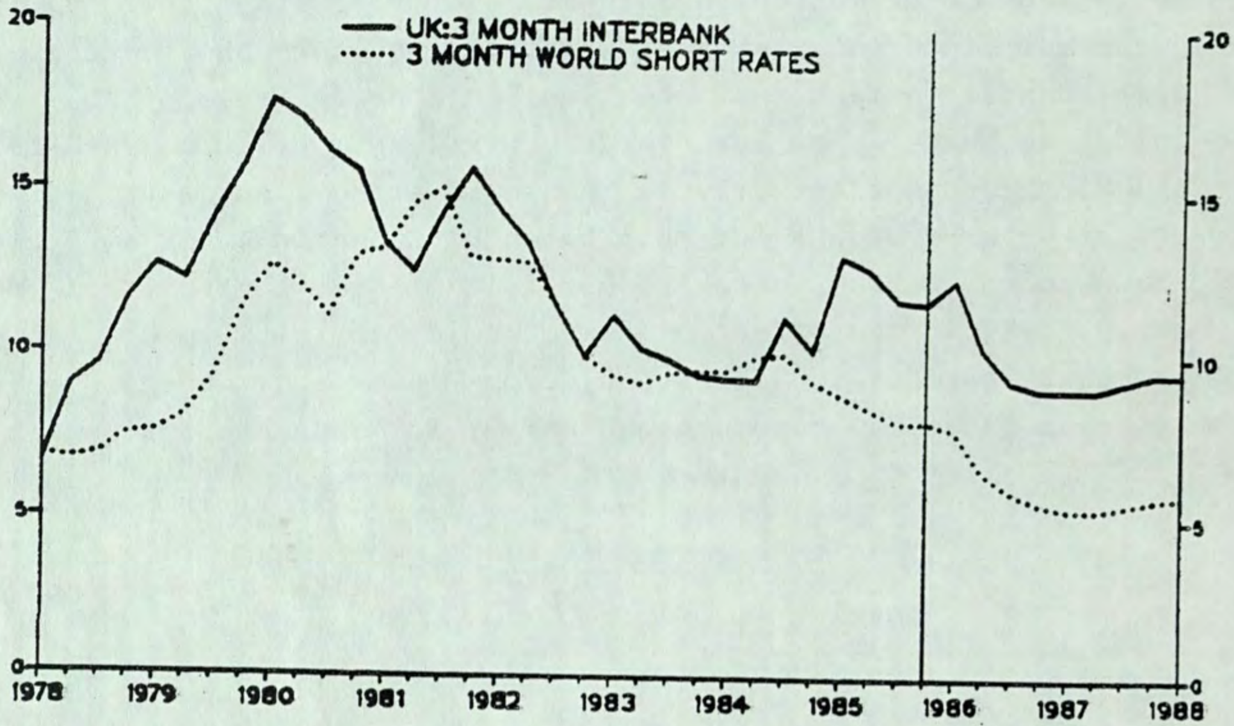
* annual average

FINANCIAL FORECAST

104. Short term **interest rates** in the UK have fallen about 2 percentage points since the Budget, a little more than the fall in overseas interest rates. Nevertheless the short term interest differential in favour of sterling, at 3 percentage points, is still quite high by past standards. Falling inflation and relatively sluggish economic activity in the world economy suggest that downward pressure on overseas interest rates will continue for a little longer and we have allowed for a further fall of over 1 percentage point by early 1987. Thereafter, as economic activity picks up and the temporary benefit to inflation from lower oil prices wears off, interest rates may rise, though mainly in North America.

	3 month interest rates		Mortgage Rate	UK 20 year rate
	World Basket	UK		
1985 Q4	8.0	11.5	12.75	10.25
1986 Q4	5.5	9.0	10.0	9.0
1987 Q4	5.75	9.5	10.5	9.0
(June 20)	(6.6)	(9.9)	(11.0)	(9.25)

105. Given the medium term prospect for a modest decline in sterling it seems likely that a positive interest differential in favour of sterling will remain necessary. The forecast suggests however that UK interest rates could fall in line with overseas rates without jeopardising achievement of the Government's monetary and inflation objectives. In other words maintenance of current interest differentials seems a plausible scenario. The resulting forecast for the levels of overseas and domestic rates is shown in the table above and chart below. The mortgage rate forecast is based on the assumption that the current differential over base rate will be maintained. In the absence of any further change in funding policy or major changes in inflationary expectations we anticipate little or no change in long rates.

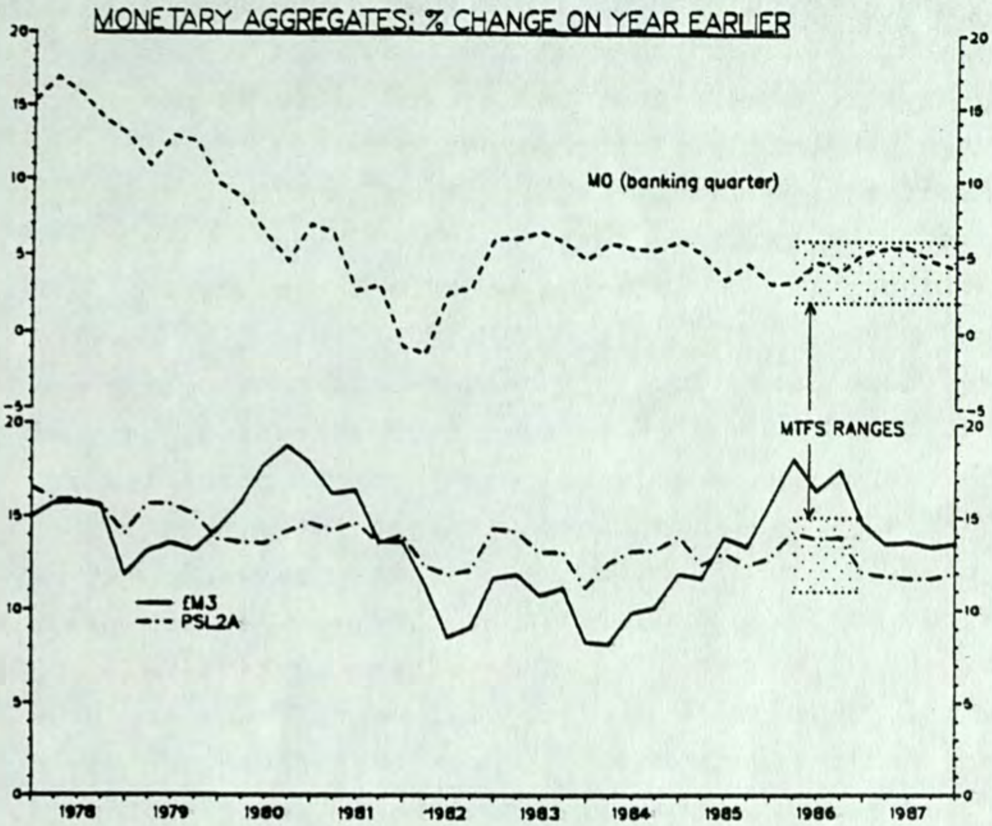


106. The forecast of the **monetary aggregates** is summarised in the table and chart below.

Average per cent growth rates in financial years

	MO		£M3		PSL2A*
	MTFS range	Outturn/ Forecast	MTFS range	Outturn/ Forecast	Outturn/ Forecast
1984-85	(4-8)	5.5	(6-10)	9.5	12.9
1985-86	(3-7)	4.4	(5-9)	13.2	12.8
1986-87	2-6	4.0	11-15	16.8	13.6
1987-88	2-6	5.1	-	13.7	11.8

* revised PSL2 from 1984 onwards



107. **MO**, currently 3.4 per cent higher than a year ago, has behaved much as expected. If, as we assume, the trend in velocity remains broadly unchanged, we expect the growth of MO to pick up through the rest of this year and during the early part of 1987. Past and forecast interest rate reductions and buoyant personal incomes and expenditure should all impart an upward boost. Although MO growth may approach the top of its target range next year, it is unlikely go above and could be back down towards the middle of the range by the end of 1987-88. **NIBM1** is more sensitive to interest rate changes than MO and its growth could well pick up more strongly. Its rate of growth is already rising, but the figure for May, 6.6 per cent on a year earlier, could well include an erratically high element. Nevertheless growth rates of this magnitude would not be unexpected for the end of 1986 and we put average growth in 1987-88 at 8-9 per cent.

108. We did not anticipate in the Budget forecast the recent surge in **£M3** growth above its target range and have little by way of explanation to add to what has been said elsewhere. The latest monthly forecast sees £M3 growth above 17 per cent in August and we are projecting similar growth rates for the rest of 1986. Thereafter we have £M3 falling back to within a 13-15 per cent range. The past record suggests however that little, if any, confidence can be attached to this forecast.

109. There are however reasons for expecting a deceleration. First building societies have been switching out of gilts into bank deposits over the past year, possibly in response to relatively high short term interest rates. While the societies' acquisition of liquid assets this year and next may be weighted towards money we doubt whether they will switch existing liquidity out of gilts to the same extent as last year. Secondly it is unlikely that stock markets will be as buoyant over the coming year and there is some prospect therefore that the balance sheets of other OFIs, and within them their money holdings, will grow more slowly than in the recent past. Thirdly once the period of falling non-labour costs is over industrial and commercial companies' profits and liquidity might increase more slowly. Finally the rate of growth of personal sector bank deposits, nearly two-thirds of total £M3, has risen over the past year as the banks' response to competitive pressure from the building societies became more effective. While the banks may compete just as effectively from now on they are unlikely to do more than hold their current market share, with bank deposits rising therefore at the same rate as total personal sector liquid assets. These are somewhat easier to predict than many other monetary and liquidity aggregates - we do not expect them to grow any faster than they are now and they may grow more slowly.

110. We expect the wider aggregates, such as PSL2A, (revised PSL2), to continue growing in the 12-14 per cent range.

111. The gross gilts **funding** requirement, at £15.7 billion for 1986-87 or rather over £1200 million a month from now on, is a little higher than at Budget time. This reflects a slightly higher PSBR, the assumed rise in the foreign exchange reserves and larger projected substitution by the local authorities of borrowing from the central government for market borrowing. This latter factor means more sales of central government debt and fewer sales of local authority debt. National savings are assumed to bring in £3 billion net. Total **market assistance** has fallen some £5.6 billion since the start of the financial year to under £8 billion in banking June, but is likely to be back around £10 billion at the end of the financial year.

ANNEX: COMPARISON WITH OUTSIDE FORECASTS

1. The table overleaf compares the June forecast with the average of outside forecasts. The forecasts used are listed below. Not all forecasts are used in calculating each average outside forecast - only those which are directly comparable.

2. The average of outside forecasts for **GDP growth** is in line with the Treasury June forecasts for 1986, but somewhat lower in 1987.

3. The average of outside forecasts shows **£M3 growth** of under 11 per cent in 1986-87 - below the 1986 FSBR target range. Outside forecasters expect the outturn for **MO growth** to be within the 1986-87 target range.

4. Since the Budget the average outside forecast for the **PSBR** has been revised downwards by around £1 bn for each of 1986-87 and 1987-88. However, the average remains above Treasury forecasts, particularly for 1987-88. (The average outside forecast is for a £2 bn **Fiscal adjustment** in 1987-88 - in line with the June forecast.)

5. Outside forecasts of the **RPI** have also been revised downwards since the Budget. But the Treasury forecast for RPI inflation during 1986 is 0.75 per cent lower than the outside average.

Forecasts used: NIESR, LBS, Phillips and Drew, Simon and Coates, Henley, Cambridge, Oxford, Liverpool, CBI, OECD, CUBS and EC.

ANNEX COMPARISON WITH OUTSIDE FORECASTS

	June forecast	Outside average	Outside range	
£M3 (% change on year earlier)				
1986-87	16.8	10.8	9.1 (LBS)	12.1 (Henley)
1987-88	13.7	10.5	6.8 (LBS)	13.6 (Henley)
PSBR (£ bn)				
1986-87	7.5	7.8	6.7 (NIESR)	9.1 (C'bridge)
1987-88	7.1	8.8	6.9 (L'pool)	12.5 (Henley)
Exchange rate (1975=100)				
1986Q4	74.4	71.9	71.0 (P&D,Henley)	73.0 (S&C)
1987Q4	70.0	69.2	69.0 (S&C,LBS,Hen)	70.0 (P&D)
Current account (£bn)				
1986	2.9	2.0	0.1 (CBI,NIESR)	8.1 (L'pool)
1987	- 1.4	0.2	- 3.2 (C'bridge)	8.6 (L'pool)
Average earnings (% change on year earlier)				
1986	7.7	7.4	6.5 (L'pool)	8.3 (CBI)
1987	7.3	6.3	4.6 (L'pool,C'bridge)	7.5 (LBS)
RPI (% change on year earlier)				
1986Q4	2.3	3.1	2.8 (NIESR,LBS)	3.5 (CBI)
1987Q4	4.0	4.2	3.0 (LBS)	5.1 (Henley)
RPDI (% change on year earlier)				
1986	4.6	3.4	2.7 (LBS)	4.1 (S&C)
1987	3.6	2.9	2.0 (CUBS)	3.4 (LBS,P&D)
Import volume: goods and services (% change)				
1986	2.1	4.2	2.3 (NIESR)	6.0 (CBI)
1987	6.4	5.0	3.5 (Henley)	6.1 (CBI)
Export volume: goods and services (% change)				
1986	0.7	2.7	0.7 (NIESR)	4.6 (CBI)
1987	3.5	3.4	2.0 (OECD)	5.9 (CBI)
GDP volume (% change)				
1986	2.4	2.5	1.9 (NIESR)	3.7 (CUBS)
1987	3.1	2.7	1.7 (NIESR)	4.7 (CUBS)
UK adult unemployment (millions)				
1986Q4	3.3	3.11	3.06 (NIESR)	3.17 (Henley)
1987Q4	3.1	3.05	2.92 (NIESR)	3.21 (Henley)

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