3333/4

CONFIDENTIAL cc Mr Norgrove - No. 10 for information

FROM: S J DAVIES
DATE: 20 August 1986

MINISTER OF STATE

cc PS/Chancellor
Sir Peter Middleton
Sir T Burns o.r
Mr Byatt
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick o.r
Mr Turnbull
Mr Culpin
Mr Mowl o.r
Miss O'Mara
Mr Riley
Mr Pickford
Mr Ross Goobey

NATIONAL INSTITUTE ECONOMIC REVIEW: AUGUST 1986

1. The August National Institute Economic Review, which includes the National Institute's latest forecasts for the UK and world economies, is to be released at 9 o'clock this evening. The review contains four additional articles: the subjects of these are the growth of services purchased by manufacturing industry, seasonal patterns in the British economy, a comparison of measures to reduce youth unemployment in Britain, France, and West Germany, and a model-based explanation of "Stagflation in the UK since 1970".

The Forecast

2. The National Institute's new forecast is based on an average oil price of $12 a barrel during 1987. As usual, the Institute are more pessimistic than other forecasters.

3. The main features of the forecast are:

- real GDP growth is 1.8 per cent this year and next;
- the annual rate of inflation picks up from 2½ per cent now to 3¼ per cent by the fourth quarter of this year and 5½ per cent a year later;

- the current account of the balance of payments is in a small deficit for 1986 as a whole (£0.7 billion); the deficit is forecast to rise to almost £6 billion in 1987;

- the PSBR is forecast at £8.6 billion in 1986-87, and £11.1 billion the following year, on the assumption of no changes in taxes beyond indexation of tax rates and allowances in the 1987 Budget.

- reflecting the impact of special employment measures, adult unemployment is forecast to fall by around 150 thousand from its current level by the end of 1987.

A table at the end of this minute gives a comparison of the NIESR forecast with our latest internal forecast and the published FSBR forecast.

The World Economy

4. The Institute note that in several countries taxes on oil products have been increased, and that OECD countries' structural budget deficits have generally been reduced this year. Together with cut backs in oil production and exploration activity, and a more general tendency of expenditure to be held back in anticipation of lower prices, this has led to a very weak world economy so far in 1986. But by 1987 the Institute expect the influence of the fall in the price of oil to be "substantially expansionary on balance".

5. Growth in the United States is forecast to pick up to 3½ per cent next year; for the OECD area as a whole GDP growth is forecast at 2.6 per cent in 1986, rising to 3.2 per cent in 1987. Consumer price inflation is also forecast to pick up in the United States next year but to be little changed elsewhere on average: primary commodity prices are expected to remain depressed. World trade is expected to rise by 3½ per cent this year and 4½ per cent next, with trade in manufactures rising by up to a point faster than this.

The UK economy

6. The Institute's forecast for UK GDP growth in 1986 is some ½-¾ of a point below both the Treasury's internal June forecast and the current average of outside forecasts. Next year the Institute expect some pick up in growth in the non-oil economy, but this is offset by a fall in oil output, so that overall the rate of economic growth is the same as this year.

7. The Institute's forecast for 1986 follows the pattern of most other forecasts for the UK in showing strong growth in personal sector income and spending, only a modest investment performance, and exports almost static. Next year consumers' expenditure continues to show strong growth; export growth picks up somewhat, but the net trade performance continues to act as a drag on overall growth in GDP.

8. The Institute have pushed up their fixed investment forecast compared with three months ago, as they have taken on board the most recent DTI Intentions survey, and the healthy prospects for private residential investment. Their forecast for non oil private sector investment is now quite similar to our own, in fact. There is a difference between us on oil investment, however, which the Institute expect to fall by 1987 to less than half its 1984 peak.

9. The relatively weak GDP performance forecast reflects both the Institute's projection of investment, and also a forecast step up in imports in the third quarter of this year (the reasons for which, at a time of rather flat demand, are not clear). This rise in imports helps to account for the scale of the forecast deterioration in the current account; but another factor here is a very pessimistic IPD forecast. The Institute expect the surplus on net profit income to be £350 lower in 1987 than in 1984 despite the large fall in foreign oil companies profits earned in the UK over this period: their projection of the IPD surplus for 1987 is almost £3 billion below that in the Treasury's internal June forecast.

10. The Institute do not offer any detailed explanation of why they expect <u>inflation</u> to pick up to as much as 5½ per cent by the end of next year. In particular, they do not make explicit what view they have taken about mortgage rates. All they say is that "real interest rates ... are projected gradually to decline": given their inflation forecast this could even mean they have allowed for a rise in nominal interest rates. It is worth noting that only three months ago the Institute were forecasting 3½ per cent inflation for 1987 Q4. The Institute's inflation forecasting record remains poor: a recent example is that in February 1985 they forecast inflation at 6.5 per cent for 1986 Q4.

11. The Institute also have a well established record of overforecasting the PSBR. A year ago, on the basis of no tax changes other than indexation in the 1986 Budget, and a dollar oil price roughly double its current level, they forecast a PSBR for 1986-87 of £11.2 billion. A year earlier their forecast for 1985-86 had been £10.7 billion (outturn £5.9 billion). The Institute's forecast now of a <u>PSBR</u> of £11.1 billion in 1987-88 differs from our own forecast in particular in allowing for continued substantial growth in debt interest payments (as noted above the interest rates projected in the forecast are not made explicit); and also very high growth in current expenditure on goods and services (almost 9 per cent growth at current prices in 1987-88, after almost 8 per cent growth in 1986-87).

<u>**The Institute's Appraisal**</u>

12. The Institute's "Appraisal" - which tends to attract press interest - notes that "the slowdown over the past year in the British economy is part of a slowdown in growth that is almost worldwide ... the volume of world trade has stagnated since early last year." On this occasion, they offer no advice on domestic economic policy. Instead they argue that Japan and Germany should expand domestic demand and that "Britain should give energetic support to this policy prescription."

13. The Institute claim that the slowdown that has occurred in the UK is "broadly in line with the forecasts we were making a year ago." This claim can be challenged. Even on the basis of their latest 1.8% growth forecast for 1986, the forecast they made 12 months ago was in fact on the low side (1.4% growth in 1986); and in February of last year they were forecasting only 0.9 per cent growth in 1986.

Line to Take on Forecast

14. The National Institute forecasters have as usual taken a more gloomy view of prospects than other forecasters; but even their forecast implies a fifth and sixth year of sustained growth. The Institute acknowledge that the slower growth in the UK economy over the last year has been closely related to world economic developments. They expect the benefits of the oil price cut to come through strongly to the world economy next year. The implication of their view about the timing of the benefit of lower oil prices is surely that prospects for UK growth in 1987 are better than their forecast implies.

SJD

S J DAVIES

CONFIDENTIAL

COMPARISON OF NIESR AND TREASURY FORECASTS

	NIESR AUGUST FORECAST		TREASURY JUNE FORECAST (UNPUBLISHED)		TREASURY BUDGET FORECAST	
per cent changes on a year earlier	**1986**	**1987**	**1986**	**1987**	**1986**	**1987 HI**
Gross Domestic Product	1.8	1.8	2.4	3.1	3	2½
Manufacturing Output	0.3	2.2	0.5	3.4	3	2½
Consumers expenditure	3.8	3.5	3.9	4.6	4	4
General government current expenditure	1.1	1.5	1.6	0.3	1	½
Gross fixed capital formation	1.8	1.1	4.3	3.3	5	0
Stockbuilding*	0.4	0.3	-0.2	0.7	0	½
Exports of goods and services	0.9	3.2	0.7	3.5	5	3
Imports of goods and services	3.9	6.3	2.1	6.4	6	5
World trade in manufactures	4.5	5-5.5	3.0**	4.6**	4½**	5**
RPI Q4	3¼	5½	2.3	4.0	3½	3½***

* contribution of change to GDP growth
** UK weighted
*** Q2

Exchange rate: sterling dollar	1.48	1.44				
Exchange rate: sterling index	74.3	70.2				
Current account (£ billion)	-0.7	-5.8	2.8	-1.4	3½	1½*
PSBR (Financial year (£ billion)	8.6	11.1			7	7

* Annual rate