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10 DOWNING STREET

From the Private Secretary

11 July 1983

The Prime Minister has seen the attached extract from Schroders Economic Perspective which was published on 4 July.

The Prime Minister has enquired whether she can make use of the argument that the growth in bank borrowing by unincorporated businesses and the establishment of a venture capital industry in the UK, support the conclusion in the Schroder extract.

I would be grateful for any other comments you may have on this paragraph, if possible before noon tomorrow.

M. C. SCHOLAR

T.J. Cassidy, Esq.,
Department of Trade and Industry.

Schroders
J. Henry Schroder Wagg & Co. Limited

Economic Perspective

Summer 1983

The UK Short Term Outlook

Sterling below $1.60 remains competitive, despite the election outcome. Continuing strong demand at home and growing demand throughout the industrial world can therefore be expected to result in increasing U.K. domestic output. Although much of the growth in demand in the U.K. is currently being satisfied by imports, business confidence is gaining and capital investment should therefore respond strongly as the recovery develops.

Leading indicators for most major industrial nations are now signalling that the recovery is gathering steam, but this will be offset to some extent by import restraint by developing countries.

In the United States, stock adjusted final demand continues to grow at around 3% p.a. — far below the average rate for the first year of recovery from recession. This may well produce, as a policy response, an attempt to bring down short term interest rates further; but, against a background of the unresolved budget deficit problem, this will not be easy to achieve. With the dollar already overvalued and the current account deficit deteriorating, some decline in the dollar can in any event be expected at some stage over the next twelve months. Any attempt to force down interest rates could of course precipitate this. Some fall in the dollar, however, would not be unwelcome to the Administration. Such developments would allow a more relaxed monetary policy in Germany and Japan, and provide an added impetus to growth in 1984, as well as removing one barrier to interest rate declines in the U.K.

The U.K. government continues, however, to be committed to paying some heed to monetary aggregates and rapid growth here could deter interest rate cuts even if sterling were to become dangerously uncompetitive again. In fact, the behaviour of the government, the personal and the corporate sectors are all likely to lead to slower monetary growth over the next year.

Government spending has been above expectations in the last few months. This represents in part the effectiveness of attempts to compensate for undershooting earlier last fiscal year and in part reluctance to tighten up before the election. From now on, however, the preferred strategy of an accommodative monetary policy and tight fiscal policy that is embodied in the MTFS is likely to be strictly adhered to, now that its author is installed as Chancellor.

The personal sector is expected to moderate its recourse to the credit market. Consumers are now over extended in terms of debt-to-income and debt-to-wealth ratios, at a time when positive real interest rates should encourage saving. Falling longer term inflation expectations and the level of unemployment are likely to restrict average earnings increases to 7% or less, putting pressure on personal incomes over the coming year (at the moment earnings are rising some 4% faster than prices). As the option of extending debt will no longer be attractive, real consumption is likely to stabilise, or possibly fall, over this period.

The corporate sector is likely to be only a moderate borrower in the upturn, not because of the level of real interest rates but because low wage settlements and an increasing share of growing markets will create sufficient profits to fund the expected increase in fixed investment (which could rise by over 10% in 1984 in response to a strong recovery and financial stability).

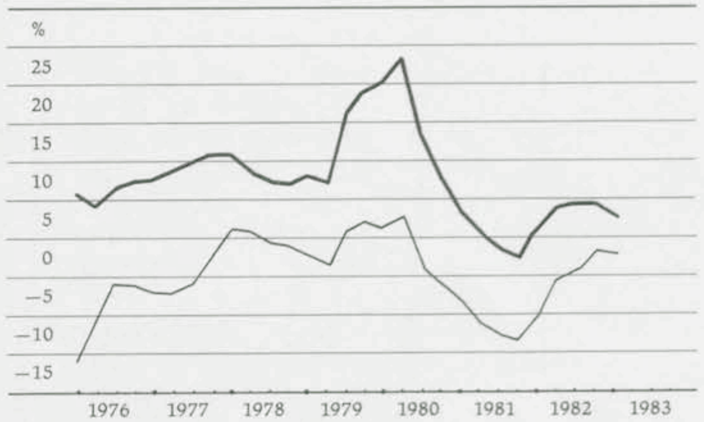
If international and domestic developments do conspire to allow the government to push down interest rates and maintain a stable exchange rate, the scene should be set for growth exceeding 3% in 1984. So far it does not appear that such growth will damage inflation prospects: unit labour costs — 60% of costs — are rising at less than 4% a year, while neither oil nor commodity prices are set to follow the inflationary pattern of earlier cycles. Moreover if real growth is over 3% from the latter half of this year, even monetary growth of 11% would not be inconsistent with an inflationary cycle peaking below 7% as positive real interest rates would continue to encourage savings and absorb excess money.

Gross total returns

%	1980	1981	1982	1983Q1	1983Q2
F.T.A. All-Share Index	+35·2	+13·6	+29·1	+ 9·1	+12·5*
F.T. Govt. Secs. over 15 years	+21·4	+ 1·5	+54·0	+ 3·2	+ 6·2*
Schroder Property Unit Trust	+21·1	+19·1	+ 8·8	+ 3·4	+ 1·4
S&P Composite Index	+23·0	+18·9	+43·7	+19·9	+ 7·5
Tokyo New S.E. Index	+18·8	+36·1	+15·6	+11·9	+ 3·8

*Estimated

Dividend Income

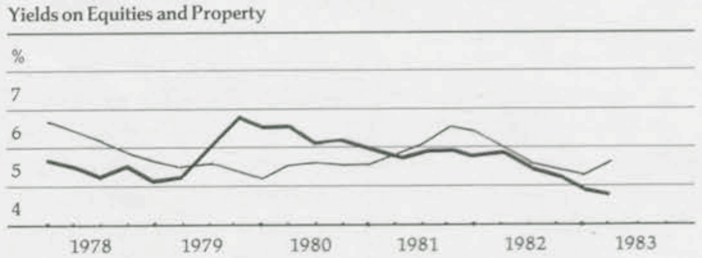


Year on Year % change of FTA All-Share dividend income

Real Year on Year % change (deflated by retail price index)

Since the second half of 1982 UK dividends are once again increasing in real terms; we expect this trend to continue through 1984.

Yields on Equities and Property

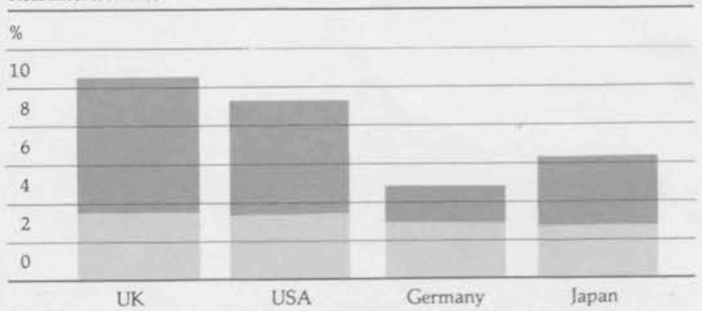


FTA All-Share Yield

Schroder Property Unit Trust Yield

There has been a major change over the last 18 months in the relative yields of UK equities and property.

Real Interest Rates



Interest rate on 3 month Eurocurrency deposits, May 1983

Annual inflation rate, May 1983

Continuing high real interest rates are an important factor in restraining the speed of the economic recovery.

Recent Market Movements

April and May saw sterling more than recover the ground lost in the first quarter, rising over 10% on a trade weighted basis. This was principally the result of the oil price stabilising, and then of growing confidence that the Conservatives would win the June election. By the end of June sterling had slipped again slightly, being unchanged over the six months.

Sterling's recovery made possible two half point cuts in the banks' base rate and improved the prospects for inflation. Nevertheless yields on long dated gilts barely improved. It was U.K. equities which produced the best return with the FT-All Share Index estimated (with the Financial Times still strikebound) to be up 11·3% over the quarter.

Despite a slight rise in short term interest rates, U.S. equities made further progress in response to the stronger than expected economic recovery. However, the gain in sterling terms was pared to 6·3%, while a more modest advance in Japan was similarly reduced for U.K. investors to 3·4%.

Outlook

Corporate profits in most major economies appear set to rise at significant real rates through 1983 and 1984. In the U.K. this would seem to be already largely discounted in current share prices. In the short term a flow of rights issues may hold back a further advance, unless this is outweighed by foreign buying in the wake of the election.

With only a very modest upturn in inflation in prospect, 11% yields on long gilts appear quite attractive.

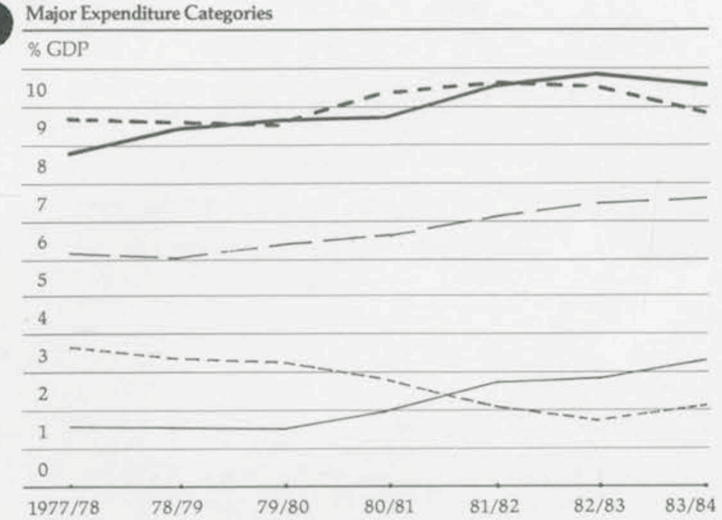
Index-linked gilts are currently friendless against a background of five more years of Conservative Government, however as yields edge above 3% there is much less likelihood of further issues and the downside risk should be very small.

The property market is gradually improving and now offers relatively attractive yields (see chart).

Overseas

The continuing high U.S. interest rates, resulting from the excessive budget deficit are likely to pose some restraining influence on markets generally and in the U.S. in particular. When also considering the relative expensiveness of the dollar against the yen and deutschemark, some shift of emphasis from the U.S. to Japan and Germany would now seem appropriate.

Major Expenditure Categories

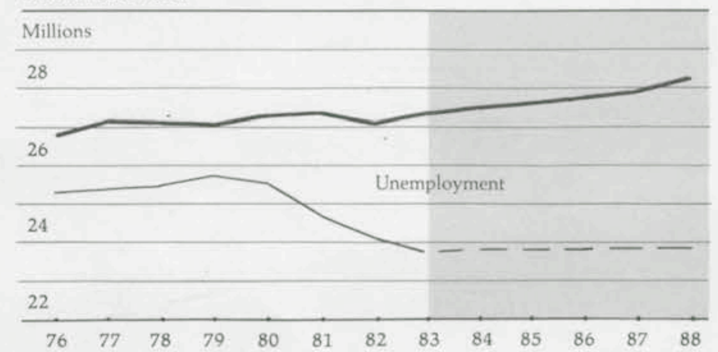


Pensions, Family Benefits, etc.
Health Education
Defence, Law & Order
Fixed Capital Expenditure
Unemployment Benefits, Dept of Employment programme

Source: Expenditure White Paper Cmnd. 8789

As GDP has fallen the proportional burden of most expenditure programmes has risen, but the rise in defence and unemployment expenditure has been particularly dramatic. As the population has aged, savings in education expenditure have been offset by rising expenditure on health and pensions. The programme has been financed by rising taxation, falling capital expenditure, (total capital expenditure — including loans and grants — has fallen from 13.2% of public expenditure in 1978/9 to 9.8% in 1982/3) and increased oil revenues (oil revenues financed 6.7% of total expenditure in 1982/3 compared with 0.9% in 1978/9).

Labour Force Trends



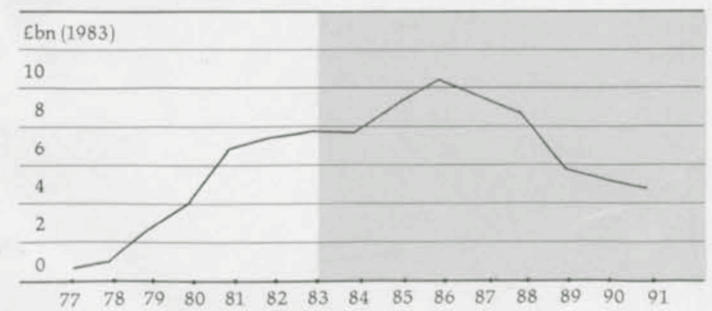
Labour force (GB) (including those seeking work who do not register as unemployed)

Employed Labour Force (GB)

Source: Employment Gazette, Schroders

Unemployment has an impact on government spending through unemployment benefits and job subsidies, and on government revenue through taxes foregone. Altogether the cost of unemployment in 1983 is about £14 bn or 5% of GDP. Over the next five years, increases in the labour force will add ¾ million to unemployment if growth does not exceed productivity gains.

North Sea Oil Tax Revenue



Source: Institute of Fiscal Studies, Schroders

Although oil revenues continue to rise to over £10 bn (in 1983 prices) by 1986, thereafter they tail off rapidly to under £5bn by 1991. Under these assumptions, of a constant real oil price from 1984 (£18.5/b1), however, falling oil revenues will not cause substantial problems until after the next election.

Prospects for Tax Cuts 1983-8

The major achievement of Mrs. Thatcher's first administration was to reduce inflation to under 5%. Her second administration, while being determined "to bring inflation lower still," will wish to concentrate upon the reduction of the role of the state, and the easing of the tax burden. This is the one major objective of the 1979 manifesto that has not been achieved — public expenditure has risen from 40½% of national income in 1978/79 to 44½% in 1982/3.

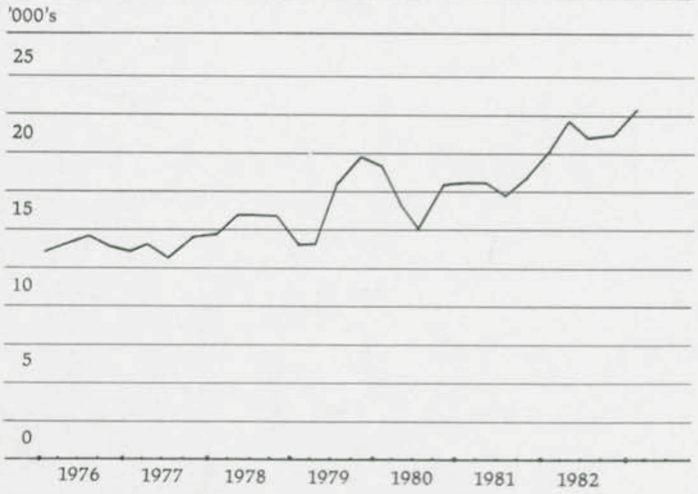
Most of the projections produced by forecasting models in advance of the election predict that over the next five years growth will average 1½-2% a year, assuming that government policy is restrictive enough to contain inflation to present levels. At these rates of growth, unemployment will stay high and government spending will fall very little as a proportion of GDP — allowing declines in borrowing in line with the MTFS but little in the way of tax cuts. If the government is not to return to the electorate in five years with its only achievement a further cut in the public sector borrowing requirement, it will either have to cut public expenditure commitments or engender substantially higher growth than is widely expected.

The trouble is, as the government has discovered over the last four years, it is not easy to cut expenditure. The government is committed to maintaining standards of care in education, health and social security, while increasing real expenditure on defence and law and order. Spending on these categories has risen from 63.8% of public expenditure in 1979/80 to 68.7% in 1982/3. There is no reason to believe that the government will be any more effective in cutting expenditure in these areas in the second term. It may be possible to achieve efficiency gains in the health service and in local authority services by tendering services to private contractors but the gains from this process are unlikely to be substantial. Pensions and family benefits absorb some 10% of GDP and it is difficult to see how savings can be made here. Defence expenditure is scheduled to increase by 3% p.a. in real terms even without the substantial Falklands commitment.

Developments in two areas considerably reduced the impact of rising current expenditure upon the taxpayer over the last four years: capital expenditure was cut dramatically, and oil revenues rose by some £6 billion. Capital expenditure cannot be cut further; indeed, if one of the ultimate objectives is growth, then any further deterioration of the country's infrastructure is likely to prove counter productive. The government has acknowledged this by its plans to increase public sector gross fixed capital formation by 22% in 1983/84.

Oil revenues will rise further in the next two years but then decline and return to current levels by 1988. Although oil revenues are thus fairly neutral for this term, they will fall off rapidly after the next election. In recognition of this, exploration incentives were included in the 1983 budget, but the North Sea is now a mature oil area, and new discoveries are unlikely to be substantial. (The discovery to production lag will ensure, in any case, that no new discoveries will be of importance over the next five years).

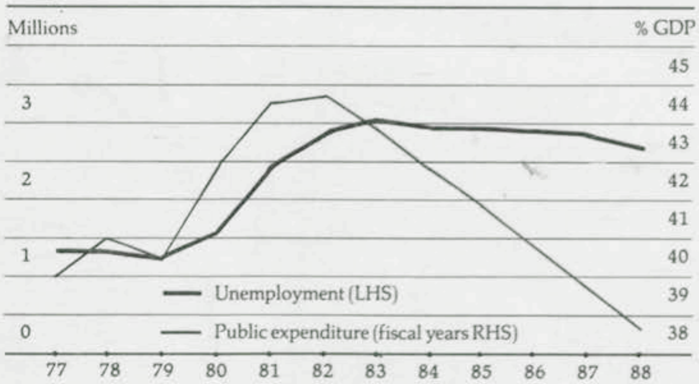
Companies Registered in GB (Quarterly)



Source: British Business

New company registrations are now running 66% above their 1976-9 average level, inspite of the recession, giving some indication that the small company policies pursued by the government are beginning to yield dividends.

3.5% growth



If the economy grows at 3.5% p.a. over the next five years, and productivity increases by 2.5% p.a., unemployment will decline by 400,000 the budget could be balanced and tax rates could be cut by 10%, even assuming that real government expenditure rises by 1% p.a.

If it is difficult to see how the government can avoid raising the real level of expenditure over the next five years, the only possible way to reduce tax rates is to increase GDP more rapidly than expenditure. Labour-intensive growth would be the most effective in reducing tax rates since expenditure on unemployment would fall as tax revenue rises. To this end the unit cost of labour has been reduced with the national insurance surcharge reductions, and by training schemes. Much more could be done: national insurance contributions could, for instance, be eliminated at the expense of capital subsidies. Labour supply has been increased at lower wage levels by measures which have reduced the ratio of the average out-of-work income to the average in-work income from 79% in 1978 to 60% in 1983. The efficiency of the labour market has been, and can be further improved by measures to increase labour mobility, such as introducing 'shortholds,' selling council houses, reducing housing subsidies and increasing the transferability of pensions (the manifesto promises to "consider how the pension rights of 'early leavers' can be better protected").

The centrepiece of the supply side growth policy of the government has been the encouragement of small businesses by means of the business expansion scheme, the loan guarantee scheme, the reduction of corporation tax, the establishment of enterprise zones and numerous other measures. That these are beginning to have a cumulative effect can be seen from the company registration statistics (see chart); from the establishment of a venture capital industry in the U.K. (only a third of the size of the U.S. industry relative to GDP — an indication of its potential); from the growth in bank borrowing by unincorporated businesses (up 36% more in 1982 than in 1981); and from the increase in self-employment (up 12% between 1979 and 1981). Growth of new companies could add appreciably to output and employment over the next five years. X

If the effect of these supply side measures is added to that of the 'new realism' in British industry — which has been responsible for the unprecedented (at least in recession) productivity gains and the unexpectedly good trade performances of the last two years — there must at least be some chance that non-inflationary growth of 3-4% can be achieved. Certainly, the achievement of rapid growth appears to be the only way in which the government can secure cuts in taxation, and a reduction in unemployment. In order to attain it the government must not only be dynamic in increasing the efficiency of markets and the growth of businesses, but must also ensure that the macro economic environment — particularly regarding money supply, interest rates and the exchange rates — is congenial.

4th July 1983

The Research Department,
J. Henry Schroder Wagg & Co. Limited,
120 Cheapside, London EC2V 6DS.
Telephone: 588 4000 Telex 885029