File

PRIME MINISTER

Pre- Summit Press Conference

Phillips & Drew are running a story about the need for a package of expenditure cuts in the summer. The Treasury are making efforts to dismiss this speculation along the lines of the attached note. This could come up at this afternoon's Press Conference. You should also seek to damp down this story by:

(i) reaffirming the Government's determination to bring inflation down further and by countering claims that the underlying rate of inflation is edging upwards;

(ii) stressing that fiscal and monetary policy is still on track;

(ii) emphasising, as Phillips & Drew concede, that UK policies are in better balance than in the US, and that this is providing some degree of protection from events abroad.

The May unemployment figures came out this morning showing a rise of 18,000 seasonally adjusted - see the attached note. You could be asked whether this indicates that the recovery is faltering. You could say that the rise in unemployment is disappointing, though other indicators of the labour market are more favourable; vacancies have now risen for three months in a row and the numbers of people in work have also been rising. The Government sticks to its belief that the creation of genuine jobs is best secured by the pursuit of sound financial policies, coupled with efforts to improve the workings of the labour market.

/ - Industrial

You could draw on the following bull points:

- Industrial output in Q1 1984 up 3½ per cent on a year earlier.

- Capital expenditure by industry up 11½ per cent in Q1 on a year earlier.

- Manufactured export volumes up 8½ per cent in Q1 on a year earlier.

- Retail spending still buoyant.

Financial markets have been in better heart today. The gilts market has risen again, by £¾ for mediums and £1 for longs. Money market rates are slightly lower at $9^7/8$ for three months. The exchange rate is firm, having strengthened against the Dollar to 1.3950. Nevertheless, you could be asked about the possibility of a further rise in base rates.

FT Index up 5.7 at 1.00 pm.

Treasury recommend the following line to take:

"I believe that money markets have been calmer today. It seems to be recognised that the short term anxieties which influenced them earlier in the week were exaggerated. As the Chancellor confirmed recently, the growth of both narrow and broad monetary aggregates remains within the target ranges set at the time of the Budget."

AT

ANDREW TURNBULL
1 June, 1984

9:4 EMBARGOED UNTIL 00.01 HOURS FRIDAY, 1 JUNE 1984 cc BR

FROM: M T FOLGER
DATE: 31 May 1984

(A)

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Bailey
Sir T Burns
Mr Cassell
Mr Battishill
Mr H P Evans
Mr Lankester
Mr Scholar ✓
Mr Culpin
Miss Peirson
Mr Shields
Mr Page
Mr A Smith
Mr MacKinnon
Mr Lord
Mr Ridley
Mr Portillo
JD/02

1 Mr Williams

2 Mr Stibbard

MLS 31/5

PHILLIPS AND DREW JUNE FORECAST

1. P&D's latest assessment will be released on Friday, 1 June. Their forecasts are summarised in the attached note. The main changes from last month's forecast include a reduction in the balance of payments current account surplus from £1½bn to £800m as oil imports increase in response to the coal strike. Their views on output growth for this year remain unchanged and broadly in line with the Treasury view. However inflation increases slightly to reach 5¾ per cent by 1985Q4.

2. P&D have taken the opportunity, in their accompanying press notice (copy attached), to start a hare about the case for "a package" similar to the July 1983 £1 billion of public spending reductions. It is not clear whether they would see this as aimed at the current year (as the July 1983 package was) or covering later years too. (In their forecast they speak of a possible overshoot on public spending in 1985-86.) The reasoning for their recommendation is obscure - though they speak loosely of "a credibility gap" having "arisen whether justified or not between the Government's pres umed intentions and its actions". They suggest that "domestic inflation expectations are now probably rising."

3. Suggested line to take:

On the forecast Output and inflation forecasts broadly in line with Budget forecast for 1984. Balance of payments figure is lower but subject to large error, just as official forecasts are.

Basis of forecast rise in inflation in 1985 not at all clear.

on a "package" (as discussed with GEP)

(i) suggestion of rising inflationary expectations not well-founded. Note that Gavyn Davies of Simon and Coates, (bulletin to be issued 4 June) reported in FT on 31 May as seeing underlying rate of increase of producer output prices as having fallen so far this year. That is consistent with Budget forecast of RPI inflation edging down through the year.

(ii) recent statistics give no reason to suppose that fiscal and monetary position out of line with Budget forecast:

(a) target monetary aggregates have recently been growing at rates within 1984-85 target ranges

(b) PSBR expected to be heavily front-end loaded and April PSBR (£2.4 billion) has to be interpreted in that context

(c) [IF PRESSED] government's supply spending in April distorted by new carry-over arrangements, in particular carry-over of £¼ billion of defence spending. So provides no reason to believe 1984-85 spending limits are threatened.

Neil MacKinnon

pp M T FOLGER

Phillips & Drew
ECONOMICS UNIT

PRESS INFORMATION

Embargo: 00.01 hours Friday 1 June 1984

Further information: Dr. Paul Neild 01-628 4444 Night: 0480-65993

TROUBLES IN PERSPECTIVE

When confidence is undermined it is easy to lose a sense of perspective regarding underlying economic trends. The large US budget deficit, US banking difficulties, Latin American debt and the response of the Federal Reserve to escalating US inflation expectations have combined to weaken confidence in the world economy. Simultaneously, a perception that the UK Government has diluted its anti-inflation stance has meant that the credibility of the Government's own economic strategy has been put into doubt at home. However, it is necessary to put these developments in perspective.

The US economy is in fundamental imbalance. This is serious. The budget deficit keeps interest rates higher than otherwise, which boosts capital inflows and underpins the dollar. The resulting uncompetitiveness of US production fosters a massive trade deficit. An upturn in activity on this basis cannot be sustained beyond the point at which inflation expectations begin to escalate. This point has been reached. The US represents 40% of free-world output. It is difficult for the UK to insulate itself from nearly half the world. This can only be done if there is absolute confidence in policies at home.

Unfortunately, this is no longer the case. A credibility gap has arisen, no matter whether justified or not, between the Government's presumed intentions and its actions. The Government's intention is presumably to keep inflation at worst on a stable path and at best on a downward path. The latest (April) output price and retail price figures have left a feeling of uneasiness that neither of these objectives is being attained. Meanwhile, the well-known front-end loading of the PSBR in conjunction with strong private sector lending has put the Government's £M3 guideline potentially in jeopardy, even though it is not being exceeded at the moment. Hence domestic inflation expectations are now probably rising, along with those in the US.

Contd/.....

PAUL NEILD DAVID ROBINS BRENDAN BROWN TIM O'DELL
STEPHEN LEWIS CHRIS ANTHONY BILL MARTIN JOHN SILLS

The first point to make here is that the UK Government is in a much better position to deal with this escalation than is the US Administration. UK fiscal and monetary policies are in much better balance. The second point to make is that, as in the US, actual cost pressures, as opposed to potential pressures, are being largely contained. A firm policy move now can stop the rather more pessimistic expectations from being turned into reality.

The Government has already accepted higher base rates. Last July the Chancellor introduced a £1bn package aimed at reducing public sector net spending. Circumstances were different then in that we had a new Chancellor operating in a post-Election environment. It is no doubt more difficult for a Chancellor to accept that similar action may be needed this year, when the ink on his first Budget is hardly dry. Yet such a package would go a long way towards restoring confidence in what is basically a much more soundly based economic revival than the example provided by the United States.

Failure to act may still see the present difficulties overcome. But it cannot be guaranteed to do so.

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PHILLIPS AND DREW (JUNE) FORECAST

Latest assessment continues to remain close to the Treasury view on output and inflation this year. 1984 GDP increases at a similar rate to last year (about 3 per cent) but with stronger contributions from exports and investment. Retail price inflation falls to about 5 per cent by end-1984, rising slightly to 5½ per cent by end-1985.

ASSUMPTIONS

- OECD real GNP grows by 4½ per cent this year reflecting continuation of strong growth in USA and accelerating activity in Europe and Japan. As a result UK export markets expand by 4-5 per cent this year and, despite a slowdown in US growth, 4 per cent in 1985. OECD inflation rises steadily over the next two years to peak at 7½ per cent in mid-1985: the impact of increasing activity is partly offset by the effect of high unemployment on earnings. Total non-oil commodity prices (in constant currency terms) rise by 2 per cent from end-1983 to end-1984 and by 3 per cent in the following year. The official crude oil price remains at $29/bl up to end-1985.

POLICY ASSESSMENT

- Argued that fiscal policy is procyclical because PSBR target of £7¼bn for 1984-85 is higher than what might have been expected once nature of Budget measures, asset sales and cyclical position are taken into account. This indicates "a shift in policy emphasis "away from concentrating on the anti-inflationary bias to policy towards concern over unemployment."

Positive fiscal adjustments are assumed to be limited to £1bn pa upto 1988-89 (amounting to less than a third of the planned cumulative fiscal adjustment of £13½bn in the new MTFS) reflecting real increases in public expenditure and "balance of payments constraints on growth and inflation." Claimed that "credibility gap" has arisen over government's anti-inflation objectives; a firm policy move (similar to last year's package) is required to dampen domestic inflationary expectations.

FORECAST DETAILS

- Little change is expected in the saving ratio but rpdi grows by 3 per cent this year and next. This underpins growth in consumer spending of 2½-3 per cent in 1984 and about 2½ per cent in 1985.

- Budget measures expected to bring forward investment expenditures. As a result manufacturing investment (inc. leased assets) rises by 10-12 per cent this year compared to 6½-7 per cent pre-budget. Total fixed investment grows by 5½ per cent in 1984.

- Rising OECD activity sees export volumes expanding by almost 6 per cent this year while non-oil export volumes expand by 4 per cent. The current account shows a surplus of £0.8bn for 1984 (down on their previous forecast) but moves into virtual balance in 1985.

- Average earnings grow by 7-7½ per cent in the current round with slightly lower settlements offset by higher wage drift. Inflationary pressures remain subdued and retail price inflation moves slowly up to 5½ -6 per cent by end-1985.

KEY INDICATORS
(May forecast in brackets)

	GDP(A) (% chg on prev yr)	RPI (% chg on prev year - Q4)	Unemployment (UK adults-Q4) millions	Balance of payments on current account (£bn)	PSBR (£bn -fiscal year)
1984	3.2 (3.2)	5.0 (4.9)	2.98 (2.97)	0.8(1.5)	8.0 (8.0)
1985	2.2 (2.1)	5.9 (5.5)	2.89 (2.85)	-0.1 (-0.6)	6.7 (6.7)

EB
31 May 1984