Hamilton MP

11th September, 1981

Private & Confidential

We had a word before the House rose and again last month about Alan Walters, with whom you and other "believers" had had a talk.

I am enclosing a copy of a letter dated 4th August, which was sent to David Hart by Alan, together with a copy of the enclosure.

I hope that this may be of some help to you.

If you would like to have a further word about this, do please do so. (930 4433).

IAN GOW

The Honourable Archie Hamilton, M.P.
House of Commons,
Westminster, London SW1

MR. GOW

ARCHIE HAMILTON, MP

I did indeed talk to Archie Hamilton. However, the nature of the point I was making was a bit different from the relationship between the money supply and output rate. What I was arguing was that there was a cycle in the unemployment rate and the inflation rate. I had investigated this in some detail up to 1971. This showed that there was a cycle of about 4½ or 5 years. This implied that if we are at the turning point in, say, January 1981, then on the average we shall be in a relatively good position in 1983. Most of the benefits of the recovery will be visible.

Even allowing for the very considerable variations in the periods of the trade cycle, it is most unlikely that we shall not be in a sustained recovery phase during 1983.

Although I have discussed this point with the Prime Minister, I have never put all these thoughts down on paper in any coherent way. But I collected some evidence for the discussion I had with David Hart on this point. You might like to see the letter and the enclosures that I sent to him. I don't see any reason why this shouldn't be sent to Archie Hamilton.

27 August 1981

ALAN WALTERS

10 DOWNING STREET

4 August 1981

Dear David

You asked me about the evidence of trade cycles in the UK. Obviously this is an enormously complicated story, but we can simplify to survive.

The best source recently is page 68 of the CSO Economic Trends for May 1981. I enclose a copy of the cyclical indicators. You will see that the average period of a depression phase (which is unshaded in figures) is a little over two years, say 2½ years. There is no depression phase over this period that exceeds two years and nine months. If, therefore, we take the longest depression phase, this would mean that the upturn would be expected to begin round about the turn of this year. This is consistent with the fact that the trough of the recession was experienced at the turn of 1980/81. The cyclical indicators in May suggested indeed that the trough had been reached in the first quarter of 1981.

All this, of course, is highly tentative, but suppose we went further and allowed another year to give us the longest depression phase in the post war years, then we would have a distinct and marked upturn in the economy beginning at the end of 1982 or the beginning of 1983.

In my view there are risks that the boom will come rather too early than too late. But of course much may happen to change the timing quite dramatically, such as political events beyond our forecasting or indeed understanding.

I am enclosing some graphs I did of the rate of inflation plotted against registered unemployment for various years, which are indicated by the last two digits. The cycles appear fairly clearly there, although I stopped at 1971 (that was when I finished this piece of work). If you continue to plot the values from 1971 afterwards you will find what Peter Jay called "Walters' screw". There are circular movements well over to the north-east on both graphs. This was the aftermath of the Heath inflation.

Yours Alan

David Hunt, Esq.

Cyclical indicators for the UK economy

Recent movements of the indicators

(*Data to 19th May*)

The movements over the last few months of the composite indices of cyclical indicators continue to suggest that the trough of the recession has been reached, possibly in the first quarter of 1981. However, confirmation must await further data.

The composite index of *coincident* indicators, which had been increasing slowly since November 1980, fell slightly in April, but this fall may be a temporary fluctuation. The high levels of retail sales in January and February had been the main contributory cause of the recent upturn. The slightly lower levels in March and April, although still significantly above those in the last quarter of 1980, have brought the composite index down a little in April. The CBI surveys into capacity utilisation and recent stock movements showed less pessimistic results in April and the rate of decline in manufacturing production eased in the first quarter of 1981, all of which would tend after detrending to increase the composite index. As usual, the most recent values of the index are based on only partial information. The coincident index does not yet incorporate any of the three measures of GDP for the first quarter of 1981. Since these are three of the seven series in the index, it is possible that the picture may alter when they are available. In particular, even if an upturn in the index is confirmed, the later data may alter the timing of the turning point.

The *shorter* and *longer leading* composite indices both continue to increase from turning points in November 1980 and November 1979 respectively. On the basis of past average relationships they point to a bottoming of the present recession, most probably around the first quarter of this year.

The cyclical indicators do not provide a guide to the strength of a recovery. The indicator system is concerned with peaks and troughs in the cyclic fluctuation about a long-term trend rather than in the absolute levels of the component series.

Definitions[1]

This section shows a reference chronology of peaks and troughs representing growth cycles in the UK economy, together with groups of indicator series which have in the past had a consistent timing relationship with the reference cycle. Growth cycles are defined as cyclical movements in the deviations from a long-term trend; thus, the contraction phase of a growth cycle occurs when the rate of growth is below this long-term value.

The historical reference chronology has been determined by examination of a range of series covering aggregate economic activity. Known special economic and climatic factors were discounted in judging the location of reference turning points. The indicators forming each group have been chosen because they have had a consistent timing relationship to the reference chronology, and because there is an economic rationale to account for this relationship.

A composite index for each group of indicators is formed by subtracting from each series the values of its long-term trend, then taking a simple average of the trend-eliminated series after smoothing, scaling to give cycles of similar amplitude, and inversion where appropriate.

Values and timing characteristics of the composite indices

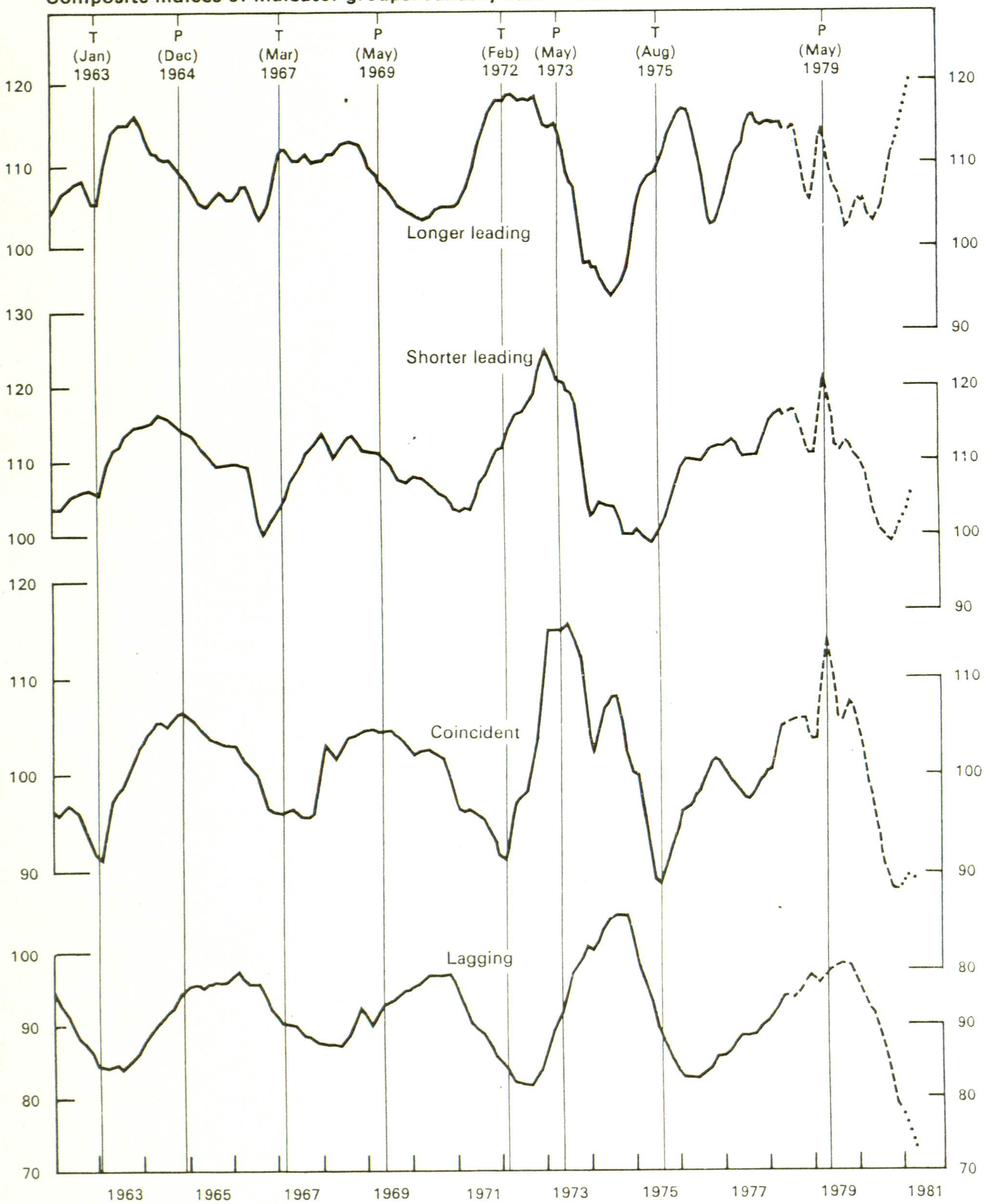
	Most recent values[2] January 1975 = 100												Lead (–) or lag (+) in months relative to reference cycle dates		
	1980								1981						
	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March	April	Mean	Earliest	Latest
Longer leading ..	103·4	103·0	103·6	104·3	106·5	108·8	111·4	112·5	113·9	116·1	118·5	120·0	–13	–21	– 7
	5	*5*	*5*	*5*	*5*	*5*	*5*	*5*	*4*	*4*	*4*	*3*			
Shorter leading ..	106·2	103·5	101·9	100·6	100·0	99·5	99·3	100·1	101·7	102·9	103·8	105·8	– 5	–12	–
	5	*5*	*5*	*5*	*5*	*5*	*5*	*5*	*4*	*4*	*4*	*2*			
Coincident ..	98·6	96·7	94·8	92·1	90·5	88·9	88·2	88·5	88·7	89·4	89·8	89·4	+ 1	– 1	+ 5
	7	*7*	*7*	*7*	*7*	*7*	*7*	*7*	*4*	*4*	*4*	*3*			
Lagging	92·1	91·0	89·2	87·1	85·1	82·3	79·8	78·9	77·8	76·2	74·6	73·2	+10	+ 3	+17
	5	*5*	*5*	*5*	*5*	*5*	*5*	*5*	*3*	*2*	*2*	*2*			

[1] A full explanation of the methodology used is given in *Economic Trends*, No. 257, March 1975 and No. 271, May 1976. Each month a chart of the composite indicators is published with, in the February, May, August and November issues, a further eight pages showing individual indicator series.

[2] In the table, the upper row presents the values of the composite indices for recent months, the lower row the number of series used to form each index. Values of the composite indices are published solely in order to show more precisely the shape of the graphs in recent months. The values are subject to revision each month, both because of revisions to the series from which they are formed and because of the nature of the trend-elimination process used in their calculation; no significance, therefore, should be attached to the current levels of the indicators, although the month-to-month changes may be used as a guide to the location of turning points. On the charts the parts of the curves which are liable to revision in the trend-elimination process are shown in pecked lines; where the composite indices are based on an incomplete set of indicators, the curves are shown as dotted lines. Additional tables giving the values of all series used are available from the CSO Press Office, 01-233 6193.

Cyclical indicators

Composite indices of indicator groups. January 1975 = 100



Hamilton MP

Professor Alan Walters

Archie Hamilton MP

1. You met him last month.

2. He tells me that you have prepared some papers for the Prime Minister about the growth in the money supply, and that these papers show a relatively encouraging position.

3. May I see these, please, so that I can decide whether any of the information there contained could, properly, be passed on to Archie Hamilton, who is David Howell's PPS and who is a staunch supporter of the Prime Minister and of the strategy?

IAN GOW
19th August 1981