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PRIME MINISTER

30 January 1987

DINNER WITH THE CHANCELLOR

The Forecast

The latest Treasury forecast shows an almost embarrassingly successful economy: real GDP continues to grow at 3%, unemployment is set to fall in 1987 to 2.85 million, and the fiscal adjustment for the next financial year is a quite extraordinary £6 billion.

The boom however is not without its cost: inflation rises from 2.4% in July 1986 to 5.3% (July-August 1987) and then falls to 4% by the spring of 1988, while the balance of payments which was in surplus (£3.5bn) in 1985 moves into deficit (£3.1bn) in 1987 (this forecast incidentally revises the deficit from £1.7 to £3.1bn) and stays in deficit throughout 1988. This is so despite the large growth in exports in 1987.

The driving force behind the expansion is a growth in money GDP (total spending) greater than the MTFPS target, a growth in narrow money - Mo - to the top of its range (and indeed in the spring of 1987, over the top), and a substantial growth in the level of public spending.

My suspicion is that the true rate of inflation in the economy is running at 4-5% and that with current growth rates the current account of the balance of payments will continue in deficit. To reduce inflation to 2% or less and to turn the balance of payments around will require a positive set of measures: but they would jeopardise growth and employment. A pre-election period is not the time for a strategic attack on our emerging problems.

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The Budget judgement

Having said that the budget should not aggravate the situation. The assumption in the forecast is that the Chancellor will cut taxes in his budget by £3bn and reduce the PSBR by £3 billion. This must be resisted.

The budget is important in creating confidence in the government's overall policies. Cutting taxes by £3bn and allowing the balance of payments deficit to grow to £3 billion would be interpreted as a political gamble to win the election. It would be out of character with the whole thrust of your appeal to the nation. And in any case it could boomerang, especially if the oil price was to fall below \$15.

My own advice in dealing with the £6 bn would be

- (a) put an absolute limit on tax cuts of £2 billion,
- (b) hide away £1½bn,
- (c) use the remainder to reduce the PSBR. (i.e. publish PSBR of around £4½bn)  
JCS

This would avoid risking an exchange rate problem and would in all probability lead to a reduction in interest rates, which could limit the rise in inflation to under 5% (just).

*MG*

BRIAN GRIFFITHS

PRIME MINISTER

MEETING WITH THE CHANCELLOR

I attach a copy of the latest forecast. This can of course change significantly in the coming weeks, with the availability of the January PSBR and other figures.

The Economic Background

The forecast presents a buoyant and, in many respects, very satisfactory picture:

- output growth of around 3 per cent in both 1986 and 1987, and manufacturing output in particular growing well this year;
- unemployment falling steadily, to below 3 million this year;
- a strong export performance, and, generally, a trading performance at a given level of demand which is better than in the 1970s;
- productivity growth several times greater than in the 1970s (see table 12);
- a profitable company sector with strong finances;
- a PSBR undershoot this year and the planning total on track both for 1986-87 and 1987-88;
- scope for large tax cuts and a dramatic reduction in the PSBR in 1987-88 with more tax cuts to come in 1988-89.

Against that:

- ←
- money GDP is set to grow significantly faster than expected at the time of the last Budget;
  - the RPI rises above 5 per cent this spring and is expected to go back to 5 per cent by the end of 1988;
  - monetary growth continues strong, with MO above its range in the next few months;
  - interest rates stay high;
  - earnings growth shows little fall;
  - the underlying fall in unemployment is very small (table 14);
  - the current account shows a £3 billion deficit in 1987 and 1988;
  - public expenditure is forecast to exceed the planning total by £5 billion in 1988-89.

← Overall, the plus factors far outweigh the negative, and it would be quite wrong, indeed perverse, to feel alarm. But there is room to question whether policy is now sufficiently tight. The Geoffrey Howe objective was "steady but not excessive downward pressure on the monetary aggregates". The forecast gives the feeling that the downward pressure on inflation is no longer there.

Arguably, underlying inflation has been stuck at around 4-5 per cent for the last three or four years, with variations around that level caused by particular factors such as varying mortgage interest and oil prices. On this basis, both higher interest rates and a lower PSBR would be needed to achieve further downward pressure on inflation. The price would be slower growth and slower progress on unemployment.

Our better productivity performance means that now we have to achieve 3 per cent growth in GDP or a little over to bring about falling unemployment. Yet at that rate of growth we seem unable to make progress towards sustained lower inflation.

The forecast has two obvious points of relevance to the timing of an election: the monthly path of the RPI (table G3 in paragraph 98) and the forecast of a £5 billion overshoot of the planning total in 1988-89, which may point to a PES round in the autumn this year much like that of 1986. (A higher planning total to accommodate the £5 billion would not affect the downward trend of public expenditure as a proportion of GDP.)

#### The Budget

This forecast assumes that the fiscal adjustment is split equally between lower personal direct taxation and a lower PSBR: that is to say, it assumes £3 billion of cuts in direct taxation and a £4 billion PSBR (more precisely £4.3 billion or 1 per cent GDP).

I understand that the Chancellor is at present inclined to accept that the PSBR should be published as £4 billion. However while he was earlier inclined to accept tax cuts of around £2 billion, his ambitions are now rising towards the £3 billion assumed in the forecast.

The size of the tax cuts will affect confidence independently of the size of the PSBR. A large "give-away" would reduce the benefits of a low PSBR. This factor will be particularly important if outside forecasts continue to show so much less buoyant a revenue picture than the Treasury forecast: some outside commentators at present see scope for tax reductions of around £2 billion with a PSBR of £7 billion, and others are more pessimistic still.

When the fiscal adjustment was put at £4 billion Terry Burns and Peter Middleton hoped for tax cuts of no more than £2 billion. That remains Terry's preference, but he accepts that the figure may now need to be a little higher. He hopes strongly that the tax reductions can be kept below £2½ billion.

Composition of the tax cuts

The Chancellor at present is looking for 2p off the basic rate, (with action to restrain the benefits for higher rate tax payers as last year) at a cost of £2.2 billion in the first year. (The lower cost in the first year arises because some higher rate tax and Schedule D tax is paid in arrears, so the benefits to those taxpayers come through after the first year.) This cost would be reduced to a little below £2 billion by the VAT avoidance measures announced before Christmas. I believe that the 0.18 per cent increase in the RPI which would result from 2p off the basic rate has not been taken into account in the forecast.

The Chancellor is also contemplating higher increases in personal allowances than the 3.7 per cent required by simple revalorisation (which still helps the poverty and unemployment traps before the social security reforms take effect), less than full revalorisation of the indirect taxes, a package of measures to help small businesses, and action on the Inheritance Tax (on which I have no details as yet).

It is not easy to judge the package with this little information, but it would be likely to fit within £2½ billion, which seems just about sustainable in itself and set against a £6 billion fiscal adjustment. The risk is that it will creep up in the coming weeks unless you state your position firmly now.

As you know, I would urge that the indirect taxes should be revalorised. If they are not put up each year it makes it more difficult to increase them when the Government needs or

wants to do so (in line with the objective of switching to indirect taxation). People at present expect them to be increased. A reduction in inflation achieved by not revalorising is also likely to have little if any effect on the underlying rate.

Tactics with the Chancellor

You might want to start by congratulating the Chancellor on the broad picture shown in the forecast. (It is not strictly his achievement, but he will want to think it is.) You could then point to the worries about inflation, money and the current account not just for this year but also looking further ahead. This points to a very firm Budget. You could at this meeting insist that you would not want tax cuts worth more than £2 billion (implying a £3 billion PSBR). The Chancellor should be made to work hard for more tax cuts than that.

The Chancellor is quite likely at some stage to say that you should not pay too much attention to the forecast for 1988 because the uncertainties are so great. He may also say we would be better off now had interest rates been increased in December as he wished. Your replies might be:

- (i) the forecasters in the last few years have several times forecast good growth in the year ahead, but slowing in the year after that; in the event the slower growth has not materialised, so inflation and the current account in 1988 are as likely to be worse than in the forecast, as better;
- (ii) at the discussion of interest rates in December you did not rule out an increase: indeed you left the way open for the Chancellor to return to argue for an increase if he wished to do so - but there has not yet been the "trigger" for an increase which you believed to be needed.

It is possible the Chancellor may try to argue for a higher

PSBR than £4 billion, as a bargaining tactic. He seems to believe (or says he believes) that private sector borrowing is now much more important for interest rates than public sector borrowing. This is surely facile: it is not at all easy to see why the two kinds of borrowing should have different effects even if private borrowing is now so much larger in scale.

### Transferable Allowances

The Chancellor has told me he does not intend to mention membership of the ERM, (though he still hankers for another discussion), but he may say that he is considering announcing in the Budget a decision in favour of transferable allowances.

It would be helpful soon to have a decision one way or the other: the Inland Revenue are at present preparing for transferable allowances, which includes using scarce and expensive computer programmers.

You will recall the arguments against transferable allowances:

- the disincentive effect on married women;
- £5 billion or so cost if there are to be no losers; (even with the basic rate at 27p)
- complexity for individual taxpayers;
- more staff at the Inland Revenue;
- couples have anyway to disclose their earnings to each other to be able to decide whether to take advantage of the ability to transfer, so there is no gain in independence unless they are willing to risk paying more tax than necessary.

The Treasury tell me privately that the public response



to the Green Paper has not been good. Most of the major public organisations are against, including the IFS and accountants, though the IOD is in favour. Emma Nicholson is in favour, but her executive two months ago turned against. Private individuals are mostly in favour, but only a small number responded (low hundreds). Some organisations which favoured the change in the response to Geoffrey Howe's Green Paper are now against, I am told.

The Chancellor is likely to say that those who oppose transferable allowances favour mandatory independent taxation and higher child benefit. This is unacceptable, and something must be done.

But why need anything be done? There is some concern and pressure. But it is not widespread, and there is no agreement on what should replace the present system.

If the Chancellor insists on pushing his proposal, I suggest you ask first for a full analysis of the responses to the Green Paper.

#### Oddments

- (i) Based on monthly figures the cumulative current account surplus under this Government has been £20,574 million. My figure of £20 billion was based on the quarterly series and counted April 1979 as conservative. I suggest sticking with £20 billion, since there are likely to be deficits in the coming months;
- (ii) export volumes are at record levels with or without oil and erratics. This can be reconciled with a fall in the value of exports, because in the volume series the contribution of oil is calculated using the oil price in the base year, 1980.

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Protection of Sources

The information on the Chancellor's views about the Budget and on reactions to the Green Paper on transferable allowances is based on information given to me in confidence by people in the Treasury. Please do not show that you know it. It would also be helpful if discussion of transfereable allowances came as a surprise to you.

DN

DAVID NORGROVE

30 January 1987

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## TREASURY ECONOMIC FORECASTING EXERCISE

## JANUARY 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

INTRODUCTION

This report summarises the results of the internal Treasury forecasting exercise. Most copy recipients will receive in addition copies of more detailed reports on

**World Economic Prospects** (Mr Matthews, IF2),

**Public Finances** (Mr Mowl, PSF),

and a short summary of

**The Financial Forecast** (Mr Bottrill EA2).

2. The forecast covers the period to the end of financial year 1988-89. It therefore covers two of the four financial years which, if past precedent is followed, the next MTFS will cover. The budget Industry Act forecast will cover the period to mid-1988.

Assumptions

3. The forecast assumes that the overall stance of policy will continue to be broadly as set out in successive versions of the MTFS.

- It is assumed that the aim of interest rate policy will be to achieve monetary conditions reasonably close to those envisaged in the 1986 MTFS. Strictly interpreted this would have involved a path for money GDP close to that set out in the 1986 MTFS and MO being near the middle of its 1986 MTFS target ranges. The forecast assumes nominal interest rates are kept constant at their current level even though the growth of money GDP is projected to be above the MTFS path, and MO is towards the top half of its target ranges in 1987-88 and 1988-89.

- For the current financial year (1986-87) there is a direct forecast of the PSBR on the basis of existing tax rates and the best current assessment of the outcome for public expenditure. For future financial years large fiscal adjustments would be forecast to accrue on the assumption of the PSBR ratios in the 1986 MTFS. Half of these fiscal adjustments are assumed to be used to reduce personal income tax and half to lower the PSBR. The forecast

therefore assumes lower values for the ratio of the PSBR to money GDP than set out in the 1986 MTF5. Other than for personal income tax the forecast assumes constant tax rates and (revalorised) allowances throughout and no changes of regime for particular taxes.

- The forecasters have attempted to produce a realistic path for public expenditure, given the current approach to overall fiscal policy. The forecast totals for public expenditure therefore attempt to take account of likely additions to plans in future rounds of Ministerial discussions. (Annex A summarises the assumptions on particular components of public expenditure.)

#### A: SUMMARY OF RESULTS AND MAIN ISSUES

4. Table A1 summarises the principal results of the forecast. It is essential to bear in mind the very large margins of error around the forecast and in particular of projections of the PSBR and of the current account and its constituents. Annex B gives average recorded errors for the main forecast variables in recent years.

#### Comparison with main industrial countries

5. Table A2 compares growth of demand and output in the world and UK economies. The latest information suggests that the (high) growth of real domestic demand in the UK was broadly similar to that in the rest of the G7 in 1986 bearing in mind the probability that the expenditure measure of GDP in the UK is likely to be revised up. For 1987 domestic demand at home and abroad is expected to continue to grow at about 3½ per cent - with growth in the UK possibly a little higher than in the rest of the G7. The forecast implies a fall in the UK personal saving ratio in 1987, but little further fall for the average of the rest of the G7 as a whole. Fixed investment and stockbuilding are likely to make a greater contribution to demand in the UK in 1987, having been somewhat depressed in 1986.

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TABLE A1 : SUMMARY OF THE FORECAST

	MARCH 1986 <u>FSEB/MIFS</u>	NOVEMBER 1986 INDUSTRY ACT <u>FORECAST</u>	JANUARY 1987 <u>FORECAST</u>	JANUARY 1987 AVERAGE <u>OUTSIDE FORECAST</u>
<u>THE WORLD ECONOMY</u>				
1. <u>World GNP (major 7)</u> (per cent change on year earlier)				
1986	3.4	2.6	2.6	N/A
1987	3.6	3.1	2.9	N/A
1988	3.2	3.0	3.0	N/A
2. <u>World Domestic Demand</u>				
1986	3.6	3.5	3.8	N/A
1987	4.6	3.4	3.3	N/A
1988	4.1	3.2	3.1	N/A
3. <u>World Trade in Manufactures</u>				
1986	5.1	2.2	1.7	N/A
1987	4.9	4.3	3.6	N/A
1988	4.8	4.7	4.1	N/A
<u>UK ACTIVITY AND DEMAND</u>				
4. <u>GDP volume</u> (per cent change on year earlier)				
1986	3.1	2.3	3.0	2.3
1987	2.4	3.0	3.1	2.7
1988	2.7	3.3	2.5	N/A
5. <u>UK Domestic Demand</u> (percentage change)				
1986	3.4	3.7	3.3	N/A
1987	2.5	3.5	3.4	N/A
1988	2.6	3.7	2.6	N/A
6. <u>Unemployment (UK s.a. excl. school leavers, millions)</u>				
1986 Q4	3.13	3.20	3.14	3.17
1987 Q4	3.07	3.16	2.85	3.04
1988 Q4	3.01	2.82	2.82	N/A
<u>INFLATION AND MONEY GDP</u>				
7. <u>Money GDP per cent change on year earlier</u>				
1986-87	6.8	5.5	6.6	N/A
1987-88	6.4	7.1	7.3	N/A
1988-89	6.0	8.0	7.8	N/A
8. <u>RPI (per cent change on year earlier: RPI less mortgage interest payments in brackets)</u>				
1986 Q4	3.6(3.7)	3.2(3.3)	3.4(3.4)	3.4
1987 Q4	3.3(3.3)	3.8(3.2)	4.4(3.9)	4.9
1988 Q4	3.2(3.6)	3.9(4.0)	4.9(4.6)	N/A

After 1987 the figures are those of October the Internal forecast, updated in the light of the changed forecasts judgements for the IAF

TABLE A1 (contd.)

	MARCH 1986 <u>FSER/MIFS</u>	NOVEMBER 1986 INDUSTRY ACT <u>FORECAST</u>	JANUARY 1987 FORECAST	JANUARY 1987 AVERAGE <u>OUTSIDE FORECAST</u>
<b>PUBLIC FINANCES</b>				
9. <u>PSER - £ billion</u> (per cent of GDP in brackets)				
1986-87	7.1(1.9)	7.1(1.9)	5.2(1.3)	7.5
1987-88	7.1(1.7)	7.1(1.7)	4.3(1.0)	9.5
1988-89	6.8(1.6)	6.9(1.6)	2.2(0.5)	N/A
10. <u>Fiscal Adjustment (annual not cumulative)</u> (£ billion)				
allocated to				
(i) reducing taxes				
1987-88	2.5	2.3	2.9	
1988-89	4.0	6.2	1.9	
(ii) reducing PSER				
1987-88			2.9	
1988-89			1.9	
<b>MONETARY CONDITIONS</b>				
11. <u>Interest rates</u> (short-term) (per cent)				
1986 Q4	11.0	11.0	11.2	10.8
1987 Q4	9.5	10.4	11.0	10.1
1988 Q4	8.4	10.0	11.0	
12. <u>Money Supply M0</u> (per cent change)				
1986-87	2.6	3.7	4.6	N/A
1987-88	3.9(2-6)*	4.0	5.6	N/A
1988-89	4.9(1-5)*	4.0	4.1	N/A
* MIFS target range				
13. <u>Effective exchange rate (1975=100)</u>				
1986	73.7	72.9	72.8	68.1(Q4)
1987	71.5	67.1	68.7	65.4(Q4)
1988	69.2	65.1	67.3	N/A
<b>TRADE AND CURRENT ACCOUNT</b>				
14. <u>Volume of exports of goods and services</u> (excl. oil and erratics in brackets) (per cent change)				
1985	6.0(7.3)	6.2(7.5)	5.9(7.1)	N/A
1986	4.8(3.8)	1.1(-0.1)	2.7(1.5)	1.4
1987	3.5(4.9)	3.2(5.3)	4.3(6.1)	3.8
1988	3.3(5.3)	3.1(4.5)	1.8(4.4)	N/A

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	<u>MARCH 1986</u> <u>FSER/MIFS</u>	<u>NOVEMBER 1986</u> <u>INDUSTRY ACT</u> <u>FORECAST</u>	<u>JANUARY 1987</u> <u>FORECAST</u>	<u>JANUARY 1987</u> <u>AVERAGE</u> <u>OUTSIDE FORECAST</u>
<b>15. <u>Volume of Imports of</u></b>				
<b><u>Goods and Services</u></b>				
<b>(excl. oil and erratics</b>				
<b>in brackets)</b>				
1985	3.0(4.1)	3.0(3.7)	3.0(3.7)	N/A
1986	5.8(6.6)	5.0(5.0)	5.6(4.8)	4.8
1987	3.8(3.8)	4.6(5.5)	7.4(8.5)	5.5
1988	2.9(2.9)	4.2(3.6)	2.2(2.4)	N/A
<b>16. <u>Current Balance (£ billion)</u></b>				
1986	3.6	-0.2	-0.1	-0.3
1987	2.6	-1.7	-3.1	-3.0
1988	4.0	-3.2	-3.3	N/A



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TABLE A2 : GROWTH IN THE WORLD AND UK ECONOMIES

	1986	1987	1988
<u>Major 7 (excl. UK)</u>			
Domestic Demand	3 <sup>3</sup> / <sub>4</sub>	3½	3
GNP	2½	2 <sup>3</sup> / <sub>4</sub>	3
Potential GDP	2 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>
<u>UK</u>			
Domestic Demand	3½	3½	2½
GDP	3	3	2½
Potential GDP: whole economy	2 <sup>3</sup> / <sub>4</sub>	2½	2
non-oil	3½	2 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>

6. For the G7 as a whole domestic demand growth in 1987 and 1988 is a little above potential output growth. In the UK the gap between domestic demand growth and potential output growth (whether whole economy or non-oil) is greater than in the G7, notwithstanding the upward revision to the estimates of UK potential output growth since the 1986 MTFS.

The World Environment

7. Table A3 summarises the prospect.

TABLE A3 : THE WORLD ECONOMY  
(latest OECD forecast in brackets)

Percentage changes on a year earlier	1986	1987	1988
G7* Real GNP	2.6(2½)	2.8(2 <sup>3</sup> / <sub>4</sub> )	3.0
G7* Industrial Production	1.2	2.7	4.2
G7* Consumer prices	1.8	2.2	3.1
G7* Exports	1.9(1½)	3.5(3 <sup>3</sup> / <sub>4</sub> )	4.3
OPEC and NODC Imports	-8.4(-5½)	-1.1(- <sup>3</sup> / <sub>4</sub> )	3.9
Total world imports	4.6	3.7	4.1
World trade in manufactures+ (UK weighted)	1.7	3.6	4.1

\* excluding UK

+ Main industrial countries exports of manufactures

8. In the developed economies inflation should remain low and domestic demand grow strongly. The forecast assumes a mild policy loosening (which will in effect moderate the pace of previously planned tightening)

in Japan and Germany. This bolsters domestic demand from the second half of 1987 onwards. Even though the forecast has a little further macroeconomic policy adjustment after 1987 in the US, there is not likely to be much progress in reducing external payments imbalances.

9. In 1986, following the oil price fall, the major developed economies experienced a strong growth of imports as domestic demand grew strongly. At the same time both OPEC and non-oil developing countries (NODCs) continued to cut back sharply on imports. The resulting weakness of G7 exports - including UK exports in the early part of the year - was an important factor in the low growth of industrial/manufacturing output.

10. The prospect for developed country exports will be heavily influenced by the pace at which both NODCs and OPEC continue to cut imports, and how soon they eventually start to increase them. This forecast assumes a slightly less marked pick up in NODC imports than previously predicted, because real commodity prices seem likely to rise more slowly than expected in the autumn from the record low levels of 1986. World trade in manufactures is forecast to rise at 3½ and 4 per cent in 1987 and 1988 respectively - rather less than forecast at the time of the Autumn Statement.

#### Demand and output in the UK

11. Interpretation of the recent growth of activity in the UK has been hampered by large discrepancies between the output, expenditure, and income measures of GDP. The output measure suggests growth of about 3½ per cent in the year to 1986Q3; the other measures suggest growth of around 1-1½ per cent. The past experience of revisions to these measures suggests that it is better to use the output measure, rather than the average of the three measures. The forecast has GDP growing in line with the output estimate of GDP in the year to 1986Q3. This means the estimate of real GDP growth is about ½-¾ per cent higher for 1986 than would be implied by the published estimates for the average measure for GDP until 1986Q3. The estimate for money GDP growth in 1986-87 is about 1 per cent higher than would be obtained from the published estimates for the first half of the financial year.

12. The implication of this interpretation of the data is that present published estimates understate the recent growth in some of the components of expenditure and income. In particular it is likely that corporate profits are one of the components affected. Given the importance that the data for recent profits have for the projected level

of company taxes, for the purpose of the tax projections the forecast has assumed additions of £1 billion and £1½ billion to the published figures for corporate profit for 1985 and 1986 respectively.

13. In 1986 as a whole the volume of non-oil visible exports (excluding erratics) grew by 2 per cent - well below the 5½ per cent growth of the volume of visible imports. As a result GDP grew 1 per cent more slowly than domestic demand. A further rise in world trade in manufactures, together with the recent gains in competitiveness, should enable the growth in non-oil visible exports to continue during 1987. The UK may slightly improve its volume share of the main developed countries' manufacturing exports (the measure the forecast uses for world trade in manufactures). In 1987 the volume of non-oil visible imports is again likely to grow more quickly than the volume of exports, but this pattern may be reversed in 1988. Trading performance is therefore likely to continue to constrain GDP growth in 1987 (though by less than in 1986), with some levelling off during in 1988.

14. The current strong growth in domestic demand in the UK is likely to continue in 1987, with some pick up in investment. Large fiscal adjustments allocated to personal income tax in 1987 and 1988 help to maintain the growth of consumers' expenditure at a high level, though there is some fall off in both years compared with 1986.

15. As table A1 shows, strong growth in UK domestic demand in 1986 is broadly in line with expectations at the time of the 1986 MTFs and earlier forecasts. The composition, though, has been different, with higher consumers' expenditure and a more negative contribution from stockbuilding. In 1987 growth of domestic demand is projected to be higher than expected in the 1986 MTFs, with prospects for non-manufacturing investment now very promising in the light of the latest BSO survey, and residential investment also rising strongly.

#### Productivity, employment and unemployment

16. Productivity grew slowly between the first halves of 1985 and 1986, but picked up again, along with the rate of growth of output, during 1986. Productivity in 1987 and 1988 is forecast to average 2 per cent in the non-oil economy as a whole, and around 4½ per cent in manufacturing.

17. Unemployment has fallen by 107,000 in the last five months, and this rate of fall may be maintained through much of 1987. As employment responds to movements in output with a lag, the rate of growth of

employment should be higher in 1987 than in 1986. The main impact of the 12 month Restart programme will have been felt by the spring of 1987 but the soon to be announced new package of measures will quickly start to have an impact on the count. The forecast has a decline in the growth of the labour force, even after making allowance for the rather high growth of population that OPCS now expect.

### The current account

18. The current account worsened markedly through 1986. A sharply lower surplus on oil trade and a further deterioration in non-oil visible trade was only partly offset by a much higher surplus on invisibles. The prospect is for the current account to deteriorate a little more in 1987 from the announced rate in the second half of 1986 and then to level off in 1988.

TABLE A4 : THE UK CURRENT ACCOUNT (£b.)

	Trade balances for goods				Net Invisibles			Total Current Account (share of GDP in brackets)
	Fuel Total	(o/w Oil)	Manufac- tures	Other	Services	IPD	Transfers	
1985	6.6	(9.2*)	-3.0	-7.3	5.8	3.4	-3.6	3.5(1.2)
1986	2.7	(4.2)	-6.2	-6.7	5.8	5.2	-2.4	-0.1(0)
1987	2.4	(3.8)	-9.4	-7.4	6.4	7.0	-3.5	-3.1(-0.)
1988	1.5	(2.8)	-10.3	-6.9	7.1	6.9	-3.1	-3.3(-0.)

\* adjusted for the coal strike

The mild upturn in the growth of world trade in manufactures and the lower real exchange rate should both have a favourable impact on the current account. In addition the forecast consciously assumes a continuation of the better trade performance of the early 1980s. This assumption on trade performance means that when there is no change in competitiveness and when demand at home and abroad grow at sustainable rates there is no tendency for the UK to lose share in the main developed countries' manufactured exports or for the volume of imports to rise more quickly than on average in comparable developed economies. On the other hand the forecast has a bigger gap between the growth of domestic demand and potential output in the UK than in the rest of the G7 (see table A2). The surplus on invisibles is projected to rise less strongly; current account deficits involve a slower growth of the UK's stock of external assets. By 1988 the tighter fiscal policy and improved competitiveness lead to some turn round in the non-oil current account, although the

decline in the oil surplus delays the improvement in the overall current account.

### Inflation

19. The prospect for RPI inflation in 1987 has deteriorated a little since the Autumn Statement forecast. Pay settlements in the private sector have fallen in the current pay round. For the round as a whole the forecast has them on average a point lower than last year. The prospects for a further fall in settlements in the following (1987-88) pay round are not favourable as RPI inflation will probably be relatively high over the summer months. Materials costs have been rising again since the summer; if sterling now stabilises they may not rise much further for a while. RPI inflation is likely to be higher at the end of 1987 than it is now, at almost 4½ per cent: the increase in the RPI excluding mortgage payments may be almost 4 per cent in the year to 1987Q4, compared with 3½ per cent over the latest twelve months. Inflation will pick up somewhat more in 1988 if, as assumed, sterling starts to fall again and world commodity prices gradually recover from their currently very depressed levels.

### Monetary policy and conditions

20. With growth of nominal demand likely to remain strong through 1987 and 1988 there may be little scope for any reductions in nominal interest rates. The projected growth of money GDP is above the path set out in the 1986 MTFS by a percentage point in 1987-88 and rather more in 1988-89. MO also grows towards the top of the target ranges published in the 1986 MTFS.

21. Against this background the forecast has a flat path for short term nominal interest rates at their present level, and a modest exchange rate fall, averaging 2 per cent per annum from the current level. If there turns out to be greater downward pressure on the exchange rate, higher short term interest rates could be necessary. Such downward pressure on the exchange rate could occur if financial markets are adversely affected by the slight rise in inflation, MO growth at the top of or above its current ranges, or large current account deficits. Oil prices above the \$15 path could offset these pressures.

Public Finances

## (a) 1986-87

22. The PSBR in 1986-87 is very likely to undershoot the FSBR and Autumn Statement forecasts of £7b. The latest estimate with three months to come is that the outcome will be £5½b.

23. The forecasters' judgement is that the outcome for the public expenditure planning total could be £140.3b., much the same as in the Autumn Statement, after allowing for the extra expenditure that Rover will involve. The forecast assumes that those additional payments to teachers in England and Wales under the Baker proposals that were previously expected in the current financial year will slip into 1987-88. As usual the difficulty of predicting expenditure at the end of the year creates a fair degree of uncertainty about the outturn for expenditure in the year as a whole. The forecast assumes a slightly larger end-year surge than usual for some categories of expenditure; because this surge might not occur to the extent assumed total expenditure could turn out to be lower than forecast.

24. The likely PSBR undershoot in 1986-87 is, however, much more the result of unexpected developments on the CG revenue side, and with LA's and PC's borrowing. So far in 1986-87 there has been an extraordinary overshoot on Corporation Tax, and to lesser extents on VAT and Stamp Duty.

## (b) 1987-88

25. The fiscal prospects for 1987 and 1988 appear to be very good. There is a reasonable prospect of the outcome for the public expenditure planning total being close to the announced plans in 1987-88. Only modest overspends compared with programme plans are forecast for most categories of expenditure. And while pressures on central government pay may be somewhat greater than in recent years falls in unemployment should moderate upward pressure on social security expenditure. The forecast has added just over £1b. to the non-demand sensitive components of public expenditure to produce realistic increase in real terms in the light of past experience. This allowance could prove to be too large if the discretionary increases in cash limits which are implicit in the forecast, and are larger than in recent years, do not occur to the extent implicitly assumed.

26. For 1988-89 the forecast assumes expenditure some £5b. above the recently announced plans. This is a somewhat greater longfall than in recent years. Even so when the next round of Ministerial discussions on the expenditure plans occurs in the autumn, the economy will have been growing at close to 3 per cent for six and half years and, there will be plenty of evidence on the buoyancy of government revenues. There could therefore be even stronger upward pressures on expenditure than the forecast assumes for 1988-89. The forecast does not assume that the upward pressures on expenditure for 1988-89 will be strong enough to breach the public commitment for public expenditure to fall as a share of GDP. Indeed the shares of public expenditure in GDP in the forecast are very close to those in the Autumn Statement and PEWP because money GDP is higher.

27. On the revenue side the forecast does not assume a further significant rise in the effective rate of VAT on consumers' expenditure. In the absence of further information the increased buoyancy of the three financial years to 1986-87 is treated essentially as a once and for all adjustment. This is consistent with the buoyancy of VAT being the result, in part at least, of Keith measures already implemented - not only speeding up payments, but indirectly leading to less evasion. There is tentative evidence that there has been some shift in the pattern of consumption towards goods and services which bear VAT, but a further such shift has not been assumed in the forecast.

28. There are, however, firm grounds for projecting a further rise in the effective rate of CT if company incomes continue to outstrip the growth of investment allowable against tax. Since 1981 non-North Sea company profits have grown rapidly, and more quickly than nominal investment, hence reducing accumulated losses and investment allowances to offset against CT. The effective rate of CT has risen 5 percentage points since its low point in 1979, with a rise of over 3 points in the last two years. There is a further rise forecast for 1987-88, followed by a small fall in 1988-89.

29. With public expenditure growing less quickly than money GDP and the generally buoyant economy generating strong rises in government revenues, the forecast has large fiscal adjustments. With the PSBR/GDP ratios assumed in the 1986 MTFs the total forecast cumulative fiscal adjustment in 1987-88 and 1988-89 is around £9½., compared with £6½b. for these years in the 1986 MTFs, and £8½b. in the Autumn Statement forecast. About £3 b. of this cumulative total of £9½ b. is accounted for by the

effective rates of VAT and CT exceeding their 1985-88 levels. For this forecast only half of the fiscal adjustment is allocated to a reduction in personal income taxes in 1987-88 and 1988-89, but this still involves a cut in personal taxes of £3 b. in 1987-88.

30. The lower path for the PSBR assumed in the forecast means that the fiscal stance - as measured by the general government financial deficit - is tighter than in the rest of the G7, as table A5 shows.

TABLE A5 : GENERAL GOVERNMENT FINANCIAL DEFICITS AS A % OF GDP

	1982	1983	1984	1985	1986	1987	1988
UK : 1986 MTF5	2½	3¾	4	3½	3½*	3½*	3*
January 1987 Forecast	2½	3¾	4	2¾	2¾*	2½*	2*
G7 (less UK)	4	4	3½	3½	3½	3	2¾

\* financial years

B : THE WORLD ECONOMY

*But not if you  
daily to submit?*

### The Oil Market

31. The December OPEC agreement aims to set fixed prices for each of the main grades of oil, with an average price of about \$18 per barrel. To achieve this OPEC members are attempting to tie the oil companies with five month contracts which specify minimum purchases of oil at the fixed prices. The oil companies have so far been reluctant to sign up. Their desire not to commit themselves has somewhat reduced the availability of oil on spot markets. This has been one factor behind the rise in spot prices in January.

32. To support the fixed price system, OPEC have agreed a new set of production quotas about 0.7 mbd below the previous quotas, and perhaps 1½ mbd below actual production levels at the time of the December meeting. Such production and price agreements are notoriously difficult to police, and previous experience indicates widespread cheating on output levels and discounting of official prices. Nevertheless, there are apparently signs that the Saudis in particular have cut back production in line with their new quota, and it seems likely that most OPEC members have learnt the lesson of 1986 when overproduction at one point pushed spot prices down to \$8 pb.



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33. It is by no means certain how effective the recent OPEC agreement will be. In the last six months there has been a tendency to underestimate OPEC's ability to restrain output and raise prices. On the other hand there remains a considerable oil stock overhang, including OPEC oil in floating storage, which threatens to weaken prices, especially after the seasonal peak for oil demand. The judgement in this forecast is that the OPEC agreement will fail to sustain its aim of an \$18 pb oil price, but that there will be sufficient discipline to prevent a price collapse. The oil price falls from current levels to about \$15 pb by the middle of 1987.

34. Thereafter a rising profile of oil consumption - in contrast to the experience of the early 1980's - and slower growth in non-OPEC supply are together expected to raise the demand for OPEC oil to 20 mbd (including NGLs) by the end of 1987, and more in later years. The consequent easing of the financial pressures on OPEC may allow real increases in oil prices in the later years of the decade. (Table E1 shows the projected path for oil prices.)

TABLE B1 : THE WORLD OIL MARKET

(millions of barrels per day)

	1982	1983	1984	1985	1986	1987	1988
World demand (incl. stockbuilding)	44.9	44.4	45.8	45.4	48.0	47.9	49.4
Non-OPEC supplies	25.1	25.9	27.3	28.1	28.3	28.5	28.8
OPEC production	19.8	18.4	18.5	17.3	19.7	19.5	20.5

Demand and Activity

35. Domestic demand in the major economies was strong in 1986 and this contributed to rapid growth in their imports. (See table B2.) Growth in GNP and industrial production have been adversely affected by cuts in imports by OPEC and other developing countries suffering from debt servicing problems, weak commodity prices, or both. Industrial production and exports from the G7 could turn out to have been weaker than previously expected in the second half of 1986.

36. In 1987 domestic demand in the G7 should continue to grow strongly, and again by more than real GNP. But the gap between growth in domestic demand and in GNP should narrow. Domestic activity will once again be dependent on growth in consumers' expenditure generated by large rises in real incomes, fairly liberal credit and buoyant stock markets.

37. In Japan and Germany, the depressing effect of currency appreciations has hit domestic confidence and growth expectations; some easing of fiscal policy from the tight budgets already announced may therefore occur in order to achieve reasonable rates of growth of domestic demand and offset deteriorating positions in net export volumes. In the current international environment such easings of policy may occur, but they may not influence events until the second half of 1987 in Germany, and possibly later in Japan. In the US, further falls in the value of the dollar should at last be reflected in movements in trade volumes. However the bringing forward of consumption spending into the second half of 1986 in anticipation of the implementation of tax reform measures will probably somewhat reduce domestic demand in early 1987.

### Trade

38. There is some difficulty in putting together a coherent picture of world trade in 1986 from the incomplete and in some ways conflicting data available. Total world import volumes appear to have been about 4½ per cent higher than a year earlier. Most of the greater than expected growth is due to a rise in oil demand and a once-and-for-all rebuilding of oil stocks in the major countries. World trade in manufactures appears to have been more depressed than expected. In the first half of 1986 it was about 2½ per cent higher in real terms than a year earlier. In 1986 as a whole growth in world trade in manufactures, weighted by UK markets, may have been less than 2 per cent.

39. A major influence on the prospects for world trade in manufactures will be the extent to which OPEC or NODC's moderate the sharp cuts in their imports. Figures on G5 exports to OPEC and non-oil developing countries (NODC's) for the first 8 months of 1986 show falls of 19 and 7 per cent respectively. Without a significant rise in the oil price OPEC countries will need to cut back further on their imports throughout 1987 to reduce their current account deficits. NODC's also appear to have curbed imports in 1986. Although the newly-industrialised countries with currencies tied to the dollar have taken advantage of improved competitiveness to make sizeable gains in market share for their exports of manufactures, the position remains far from comfortable for many other NODC's. Any recovery in commodity prices in 1987 may encourage a renewed rise in import demand by NODC's as a whole, but this is liable to be smaller than expected last autumn.

TABLE B2 : WORLD TRADE

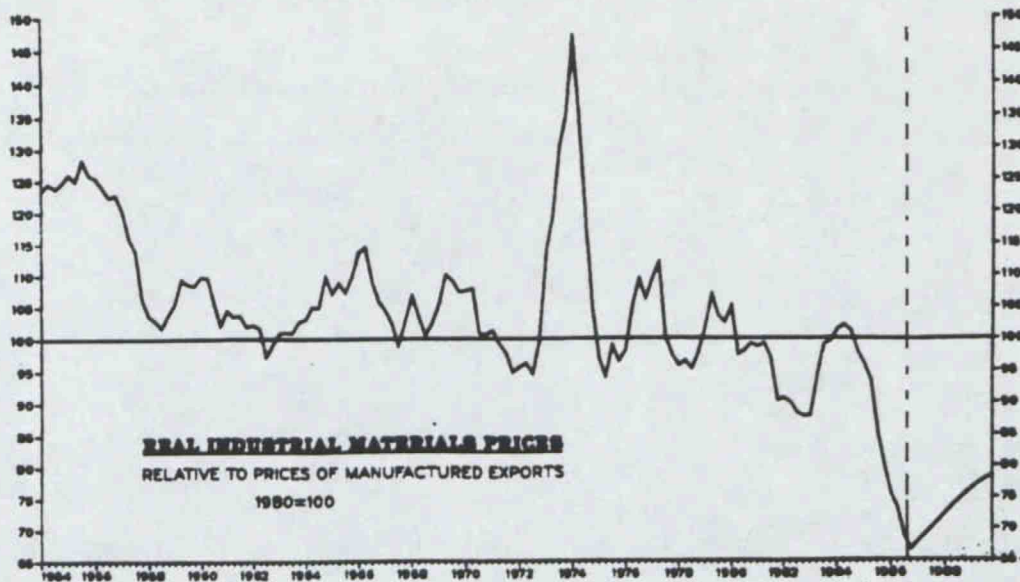
	(percentage change on previous year)				
	1984	1985	1986	1987	1988
Total world imports	8	3½	4½	3½	4
of which:-					
- G7	11½	4½	10	6	4½
- OPEC	-9	-11	-22	-24	-9
- Non-oil developing countries(NODC's)	7	4	-4	5	7
UK export markets for manufactures	8½	4½	1 <sup>3</sup> / <sub>4</sub>	3½	4

40. Total world trade is forecast to rise by 3½-4 per cent in 1987, but within this total trade in manufactures may show a stronger cyclical recovery. An end to import retrenchment by the non-oil developing countries will result in a slow recovery in G7 export volumes (see table A3).

### Inflation

41. Annual consumer price inflation in the G5 economies has fallen to less than 1 per cent, the lowest level for over twenty years. The effect of lower oil prices has probably now fed through almost completely into prices of final goods, and the annual rate of inflation can henceforth be expected to rise, perhaps to 2½-3 per cent by the end of 1987.

42. Real non-oil commodity prices have not recovered as earlier expected and food prices have, if anything, weakened further. Prices of real industrial materials remain close to the recent post-war nadir. The forecast shows a slow recovery as industrial production grows more strongly, but real commodity prices are likely to be at exceptionally low levels by post-war standards.



### Imbalances

43. The pattern of current account imbalances still poses the biggest threat to a satisfactory development of the world economy in the near future. The Japanese and German current account surpluses may be in the process of levelling off, at least relative to GNP, but there are as yet few indications of a reduction in the US current account deficit. The assumption in the forecast of no major moves towards protectionism in the US could prove to be incorrect.

44. With little sign of further progress on the Federal budget deficit (the forecast assumes a substantial cut this year - though the Gramm-Rudman target is still exceeded - and no fall in the deficit next year), there could continue to be a major loss of confidence in the dollar. In the year to 1987Q4 the forecast has the dollar effective exchange rate declining by more than 10 per cent, and by over 8 per cent during 1988. The bilateral dollar rates with the Yen and Deutschemark reach \$1 = Y120 and \$1 = DM1.50 respectively in two years time.

### **C: PUBLIC FINANCES**

45. Table C1 summarises the forecast and compares it with the FSBR numbers.

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TABLE C1 : PUBLIC SECTOR EXPENDITURE, REVENUE AND BORROWING  
(£ billion)

	1985-86	1986-87		1987-88		1988-89	
		FSBR	Jan	FSBR	Jan	FSBR	Jan
General Government Expenditure	158.5	163	165	170	174	175	185
General Government Receipts	151.6	156	158½	164	172	174	187
Fiscal adjustment allocated to cuts in taxes							
(i) From previous years -	-	-	-	-	-	2	3
(ii) Annual	-	-	-	2	3	4	2
(iii) Total	-	-	-	2	3	6	5
GGBR	6.8	7	6½	8	5	7	3
Public corporations' overseas and market borrowing	-1.0	0	-1½	-1	-1	0	-1
PSBR (per cent of GDP in brackets)	5.8(1½)	7	5½(1½)	7	4(1)	7	2(½)

1986-87

46. The Autumn Statement forecast a £7 b. PSBR in 1986-87, the same as the Budget forecast. Comparing the Budget and January forecasts for 1986-87, the picture is one in which the increase in general government receipts is only a little higher than the increase in expenditure and the lower PSBR forecast is mainly the result of lower PCMOB. The forecast of public corporations' total borrowing, the PCBR, has in fact been revised down since the Budget but not to the same extent as the revision to PCMOB. In other words general government lending to PCs has been increased, raising the GGBR. Thus the downward revision to the PSBR reflects both a lower PCBR and lower general government own account borrowing.

47. Since the Autumn Statement the forecast of the PSBR has been revised down to around £5½ b. as a result of a further upward revision to tax receipts, mostly corporation tax and VAT. Despite the assumption of expenditure of £650 millions on Rover, compared with a notional allowance of £100 million in the Autumn Statement, the forecast public expenditure planning total 1986-87 is still very close to the Autumn Statement level at £140.3 b. The addition for Rover has

been offset by reductions in central government CEGS, and local authority current and capital expenditure. The forecast is broadly consistent with GEP's January position report. General government expenditure is however a little higher than in the Autumn Statement.

48. PSF have circulated a separate note on borrowing by sector and the monthly profiles for the rest of 1986-87.

#### PSBR and Fiscal Adjustment in 1987-88 and 1988-89

49. On the 1986 MTFS assumptions about the PSBR in 1987-88 there appears to be scope for a fiscal adjustment of about £6 b., compared with an estimate of £2 b. in the MTFS itself. Although general government expenditure has been revised up by over £4 b., receipts have been increased by nearly £8 b.\* Roughly some £3b. of this increase is the result of revised judgements in the light of the unexpected buoyancy of revenues - for CT - in 1985-86 and for 1986-87. In addition personal income tax and North Sea revenues are higher than in the MTFS, by £1½ b. and £½ b. respectively. The assumption that only half the potential fiscal adjustment is used to reduce taxes produces a PSBR of £4 b. in 1987-88. The (annual) fiscal adjustment now forecast for 1988-89, at £4 b. on the MTFS PSBR assumptions, is much the same as in the MTFS.

50. The margins of error on the forecast are of course large. Over the past ten years the error on the January forecast of the current year PSBR is equivalent to £1½ b. The average error on the forecast of the fiscal adjustment for the year ahead is about £5 b.

#### Public expenditure

51. For 1987-88 and 1988-89 the forecast of public expenditure is built up to a considerable extent independently of the figures in the 1987 PEWP. The forecast takes account of (i) the differences between the economic assumptions used in the PEWP and the economic prospects as this forecast sees them, and (ii) other pressures on programmes which past experience suggests are likely.

52. Table C2 summarises the forecasters' view of the planning total.

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\*There were for presentational reasons some downward adjustments to receipts in the 1986 MTFS projections.

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TABLE C2 : PLANNING TOTAL - £ billion

		1986-87	1987-88	1988-89
1987 PEWP:	Cash	140.4	148.6	154.2
	1985-86 prices	136.5	139.3	139.6
January Forecast:	Cash	140.3	148.8	159.1
	1985-86 prices	136.3	138.8	141.3

53. The implication is that the Reserve for 1987-88 built into the PEWP will, according to the forecast, be nearly sufficient to accommodate the pressures on programme plans. For 1988-89 on the other hand the forecast suggests that there will be pressures for sizeable upward revisions to the plans in the next Survey. To some extent this reflects higher inflation in the forecast than assumed in the current plans.

54. Table C3 summarises where the forecast sees the upward pressures on public expenditure occurring.

TABLE C3 : FORECAST CLAIMS ON THE RESERVE\* - £ billion

	1986-87	1987-88	1988-89
Social Security	1.5	0.5	1.6
Central government pay	-	0.7	1.7
Other central government current expenditure	0.1	-	1.0
Net EC contributions	0.4	0.2	0.1
Other central government	0.2	1.0	1.9
Local authority relevant	2.3	1.2	2.8
Local authority capital	0.2	0.2	0.7
Nationalised industry EFLs	-	0.1	0.6
Other	0.2	-0.2	-0.1
Privatisation proceeds	0.8+	-	-
PEWP Reserves	-4.5	-3.5	-5.5
Overspend on PEWP planning totals	1.2	0.2	4.9

\* 1986 PEWP for 1986-87, 1987 PEWP otherwise

+ comprising £0.2 b. shortfall on gross privatisation receipt and £0.6 b. expenditure on acquisition of Rover shares.

55. The main features worth noting about the estimates in table C3 are as follows:

- The overspend on social security is likely to be low by recent standards in 1987-88, largely because unemployment is forecast to be lower than assumed in the 1987 PEWP, subtracting £0.6 b. from expenditure. The forecast overspend on social security reflects therefore higher take-up of benefits than assumed in the PEWP.
- The overspend on central government pay in 1987-88 is the result of assuming that central government average earnings rise broadly in line with the private sector, that is by 7 per cent. Actual payments are assumed to rise somewhat faster on account of special factors such as the staging of payments in 1986. An implicit assumption is that cash limits will be raised to accommodate most of this.
- The forecast of other central government expenditure includes an allowance of about £1 b. for genuine contingencies such as the National Space Centre and Airbus launch aid, and other contingencies which cannot be identified at this stage.
- The overspend on local authority current expenditure is also the result of the judgement that pay will increase in line with the private sector. Even on the assumption that the authorities finance some of the spending by running down balances, an average rate increase of around 8 per cent, above the rate of inflation, is forecast.

56. The forecast of debt interest and other adjustments which lie between the planning total and GGE has for 1987-88 not changed in total significantly since the Autumn Statement. The GGE forecast for 1987-88 is therefore much the same as the Autumn Statement and PEWP. The forecast of GGE in 1988-89 is much higher than the Autumn Statement and PEWP, but this reflects the higher planning total rather than any change to the 'adjustments'. Table C4 below looks at GGE excluding privatisation relative to money GDP and in real terms.



## SECRET

TABLE C4 : GGE EXCLUDING PRIVATISATION PROCEEDS

	1985-86	1986-87	1987-88	1988-89
<u>Per cent of GDP</u>				
Autumn Statement/PEWP	44 <sup>3</sup> / <sub>4</sub>	44½	44	42 <sup>3</sup> / <sub>4</sub>
January Forecast	44 <sup>3</sup> / <sub>4</sub>	44	43½	42 <sup>3</sup> / <sub>4</sub>
<u>Real terms - % change on previous year</u>				
Autumn Statement/PEWP	-0.1	2.0	1.8	-0.2
January Forecast	-0.1	1.8	1.6	1.1

57. In spite of the higher cash expenditure in 1987-88 and 1988-89 in the forecast the shares of public expenditure, both including privatisation, are either the same or below the values published in the Autumn Statement and PEWP.

General Government Receipts

58. Table C5 below shows the forecast of general government receipts relative to money GDP.

TABLE C5 : SHARES OF GENERAL GOVERNMENT RECEIPTS IN MONEY GDP  
(per cent : before fiscal adjustment)

	1984-85	1985-86	1986-87	1987-88	1988-89
Total taxes on incomes, expenditure and capital	32.3	31.7	31.1	31.8	32.0
NICs	6.9	6.8	6.9	6.9	7.1
Interest and other receipts	3.4	3.6	3.2	3.0	2.9
Accruals adjustments	0.2	-0.1	0.0	-0.1	0.0
Total	42.8	42.0	41.1	41.7	42.0
of which:					
North Sea	3.7	3.1	1.3	1.1	0.9
Non-North Sea	39.1	38.9	39.8	40.6	41.1

\* before fiscal adjustment

59. There is estimated to have been a sharp rise in the ratio of non-North Sea receipts to money GDP in 1986-87. Corporation tax

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receipts are estimated to have increased by one-third; of the other main taxes, both VAT and local authority rates are estimated to have shown increases in yield substantially higher than the rise in money GDP.

60. Table C6 shows effective tax rates - derived by dividing receipts by a suitable proxy for the tax base - for some of the main taxes. There has been a sharp rise this year in the effective tax rate for corporation tax (tax base proxy - company income in the previous year). The effective rate for VAT (tax base proxy - consumers' expenditure) has also shown a significant rise in the recent past, only part of which is explained by 1984 Budget measures extending the coverage of VAT.

TABLE C6 EFFECTIVE TAX RATES - %

	PAYE+	National Insurance Contributions	Onshore Corporation Tax	VAT*	Specific Duties
1980-81	18.8	11.5	8.0	8.0	6.4
1981-82	20.3	12.3	7.9	7.7	7.1
1982-83	20.1	13.6	9.6	8.0	7.0
1983-84	19.5	14.1	10.3	8.5	7.1
1984-85	19.0	14.1	8.8	8.7	7.1
1985-86	19.0	14.0	9.1 <sup>n</sup>	9.0	6.9
1986-87	19.0	14.0	12.4 <sup>i</sup>	9.3 <sup>i</sup>	6.8 <sup>i</sup>
1987-88	19.4	14.0	13.1 <sup>i</sup>	9.3 <sup>i</sup>	6.8 <sup>i</sup>
1988-89	19.8	14.1	12.3 <sup>i</sup>	9.4 <sup>i</sup>	6.8 <sup>i</sup>

+ before fiscal adjustment;

\* excluding VAT on imports and estimated effects of Keith changes through speeding up payments.

61. We do not by any means fully understand the reasons for these rises in effective tax rates. In the case of corporation tax possible explanations are that the buoyancy of company profits in recent years has sharply reduced losses allowable against tax and that accumulated capital allowances have fallen relative to profits. Another possibility is that profits in 1985 - the relevant year for receipts in 1986-87 - were higher than the provisional data shows. The forecast is that the effective tax rate on profits earned in 1986 will be higher than in the previous year, but thereafter a slight fall will occur as profits grow more slowly than investment.

62. In the case of VAT the two main possible explanations are first that the introduction of Keith penalties for late payments has reduced tax evasion as well as speeding up payment, and second that there has been a shift in the pattern of consumption towards goods and services

which bear VAT. The forecast assumes smaller increases in the effective VAT rate than over the last few years.

63. The forecast rise in the effective rate of PAYE (NB before fiscal adjustment in table C6) reflects real fiscal drag.

#### D: THE EXCHANGE RATE, INTEREST RATES AND FINANCIAL CONDITIONS

##### The exchange rate, competitiveness and interest rates

64. The sterling index, which fell by 14 per cent between the fourth quarters of 1985 and 1986, has remained broadly flat since early November. Crude ready-reckoners suggest that about 8 per cent of the fall to date can be attributed to the fall in oil prices. The remaining 6 per cent reflects other factors, including the relatively rapid growth of domestic money, credit and labour costs. Capital outflows have also continued at a high rate. Sterling has failed to recover significantly since the autumn notwithstanding the relative rise in UK interest rates and the firmer trend in oil prices.

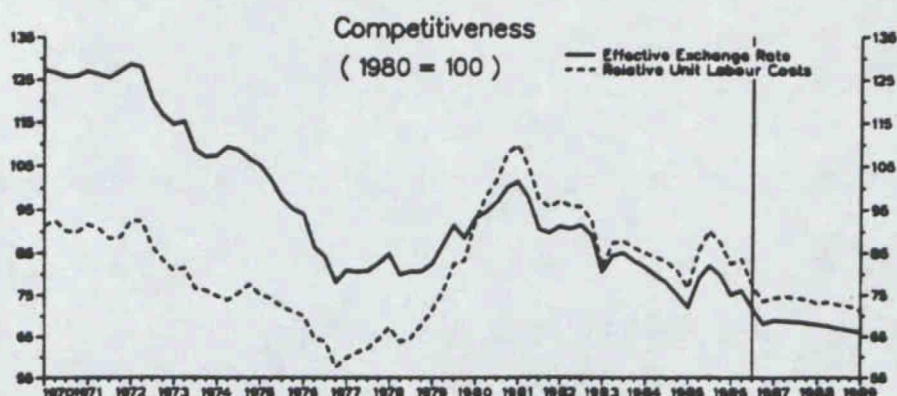
**Table D1: PROSPECTS FOR EXCHANGE RATES**

	Sterling index (1975=100)	\$/£	DM/£	Real exchange rate* (1980=100)	Relative unit labour costs (1980=100)
1984	78.6	1.34	3.79	83.2	83.2
1985	78.2	1.30	3.78	84.8	85.0
1986	72.8	1.47	3.18	78.2	79.3
January 22	69.1	1.53	2.78		
1985Q4	79.8	1.44	3.71	87.6	87.5
1986Q4	68.2	1.43	2.87	73.0	73.6
1987Q4	68.3	1.60	2.67	74.7	74.0
1988Q4	66.5	1.70	2.47	74.3	72.2

\* relative GDP deflators

65. Sterling could be volatile and at times vulnerable over the year ahead in view of uncertainties about election prospects and oil prices and if the monthly trade figures are poor. The forecast has assumed fairly arbitrarily that the sterling index remains broadly constant around 68 throughout the 1987-88 financial year. In later years, the influence of fundamentals causes it to decline by about 3 per cent a year. This path for the nominal exchange rate implies little change in competitiveness over the year ahead and a small improvement in later

years. This, together with slower domestic growth, is enough in 1988 to halt the projected current account deterioration.



66. Short-term domestic interest rates, which rose to around 11 per cent in the early autumn, have remained close to this level in recent months despite relatively rapid domestic monetary growth, the confirmed worsening in the external position and a small rise on average in interest rates in other major countries, except Japan. The rise in oil prices and the accompanying halt to sterling's decline probably helped to avert a rise in short-term rates. In the face of conflicting forces, the forecast has interest rates at their present level throughout 1987 - and 1988 - even though both money GDP and MO exceed their MTFs target growth rates - at least during the period immediately ahead.

TABLE D2: INTEREST RATES

	3-month rates		Mortgage rate	20-year gilts
	World	UK		
1985	8.3	12.2	13.2	10.6
1986	6.7	10.9	11.8	9.9
Latest rates	6.1*	10.9 <sup>†</sup>	12.3 <sup>†</sup>	9.9 <sup>†</sup>
1986Q4	6.2	11.2	11.8	10.9
1987Q4	6.2	11.0	12.3	10.7
1988Q4	6.8	11.0	12.3	11.3

\* 23 January, † 22 January

#### Monetary aggregates and credit

67. The growth of MO has risen in the past six months, reflecting the temporary fall in interest rates in the middle of last year and the more rapid increase in consumer spending. The rise in interest rates in the autumn seems unlikely to be enough to offset fully the effects of the continued rise in spending. MO seems likely therefore to rise above the MTFs target growth rate in

the current quarter and remain above it for at least part of the rest of 1987-88. In 1988-89 slower growth of consumers' expenditure should help to bring the rise in MO back within the 1986 MTFs range.

68. An important uncertainty is the extent to which financial innovation will continue to reduce the demand for MO. It could be that the major part of the shift from cash to non-cash transactions is now nearing completion, and future innovation may increasingly take the form of substitution between different forms of non-cash transactions. The forecast has innovation reducing the growth of MO by about 3 per cent a year - broadly in line with average experience since 1983.

**Table D3: MONETARY AGGREGATES**  
(percent change on a year earlier)

	MO	Actual/ forecast	MTFS range	£M3	Actual/ forecast	PSL2 Actual/ forecast
1985-86		4.3	-		13.0	12.8
December 1986		5.4			18.0	14.7
1986-87	2-6	4.6	11-15		18.5	14.2
1987-88	2-6	5.6			15.7	12.8
1988-89	1-5	4.1	-		13.1	11.9

69. £M3 has continued to grow more rapidly than the MTFs target range with an increase in bank deposits by persons, companies and building societies reflecting rising incomes and gross financial wealth. The forecast is for slower growth as personal incomes and wealth rise less rapidly, and companies' financial surplus declines. The velocity of £M3 which appears likely to have fallen by about 10 per cent in 1986-87, is forecast to fall by about half that rate in future.

**Table D4: BANK AND BUILDING SOCIETY LENDING**  
(percent change on previous year)

	Bank lending to private sector	Building society lending	Bank and building society lending
1985-86	17.8	18.5	18.1
1986-87	18.9	19.1	19.0
1987-88	20.1	16.8	18.8
1988-89	17.5	15.1	16.5

70. Bank lending to persons has continued to rise steeply despite high interest rates which are contributing to a large increase in the debt service ratio. Lending to industrial companies has also picked up

recently, and borrowing by financial institutions has risen with Big Bang. The forecast assumes that personal sector borrowing will continue to rise - albeit less rapidly. Lending to companies grows relatively modest as companies rely more on security issues. The widening in the current deficit implies that banks will rely more on deposits from overseas. This change in the composition of banks' balance sheets means of course that £M3 will be lower than the growth of domestic credit.

71. PSL2 growth has picked up less than £M3 as deposits have been transferred from building societies to banks. This process is now thought to be complete and the forecast has a gradual convergence of growth rates on a downward path as both bank and building society deposits grow less rapidly in future.

72. A feature of the forecast is that with a low PSBR, net gilt sales fall sharply and the National Savings target is assumed to be reduced so that institutions and persons need to find alternative assets to hold either at home or abroad.

#### Sectoral financial balances

73. The personal sector surplus is likely to continue to fall over the forecast period, reflecting at least partly the decline in the saving ratio. The rise in the personal sector's gross financial wealth/income ratio comes to an end, but while there is a further rise in the ratio of liquid assets to income this is less than the rise in the debt/income ratio. Income gearing also continues to rise.

**Table D5: SECTORAL FINANCIAL BALANCES**

(£ billion, + = surplus)

	Personal sector	Industrial companies N. Sea	Other	Financial companies	Total private	Public sector	Over-seas
1985-86	9.7	-0.9	6.6	-0.2	15.2	-8.9	-4.1
1986-87	7.0	-1.0	5.9	-0.4	11.5	-10.5	1.2
1987-88	7.5	-0.4	2.7	-0.8	9.1	-9.6	3.5
1988-89	6.2	-0.0	3.4	-1.6	7.8	-8.2	3.2

74. The projected fall in non-North Sea industrial and commercial companies' surplus should not impose any excessive strain since companies' liquidity ratios are historically high, and they have relatively easy access to finance - either from banks or the securities markets. The overall fall in the private sector surplus more than

offsets the reduction in the public sector financial deficit, leaving a gap to be filled by the overseas sector which is mirrored in the current account deficit.

75. The emergence of a current deficit implies a reversal of the net capital outflows of recent years. Net outflows of both oil and non-oil direct investment seem likely to continue at broadly their past rate. Financial institutions also seem likely to continue to invest overseas and increase the share of foreign assets in their total portfolio, but increased security issues by UK companies could reduce overall net portfolio outflows. Banks likewise are expected to sustain their portfolio investment and foreign currency advances, but also to increase their liabilities at a similar rate. The main financing of the current deficit, however, is assumed to come through a net increase in banks' sterling liabilities to overseas residents. This relies on the positive interest differential being adequate to attract the necessary funds. Any weakening of confidence could put renewed pressure on interest rates and the exchange rate. The balancing item, which amounted to £6 b. in the first three quarters of 1986, is assumed to revert to its long-term average of about £1 b. a year in 1987 and 1988.

TABLE D6: NET EXTERNAL CAPITAL FLOWS

(£ billion)

	Direct investment	Portfolio	Banks			Balancing item	Current account
			Foreign Currency	Sterling	Other		
1985	-4.0	-11.0	4.9	2.5	-0.1	4.1	3.5
1986	-1.8	-14.4	13.0	-0.7	-2.2	6.2	-0.1
1987	-2.6	-12.7	11.5	8.3	-2.4	1.0	-3.1
1988	-3.1	-10.2	11.1	8.9	-1.5	1.0	-3.5

76. The effect on the UK's net foreign assets of the increased net borrowing over the forecast period is projected to be more than offset by sterling's depreciation and the projected continued rise in foreign stock markets - although the latter assumption is particularly arbitrary. These contribute to increase the value of net foreign assets from £80 billion at end 1985 to about £110 billion by end-1988.

#### E: THE NORTH SEA FORECAST

##### Prices

77. The Brent spot oil price is currently close to \$18½ a barrel

compared to an average of about \$15 in 1986Q4. Prices are assumed to ease to about \$15 a barrel by 1987Q3 in line with the projected weakening of world oil prices, discussed in section B. Thereafter the assumption of fixed real world prices coupled with the projected decline of the pound, implies a renewed rise in Brent prices in sterling.

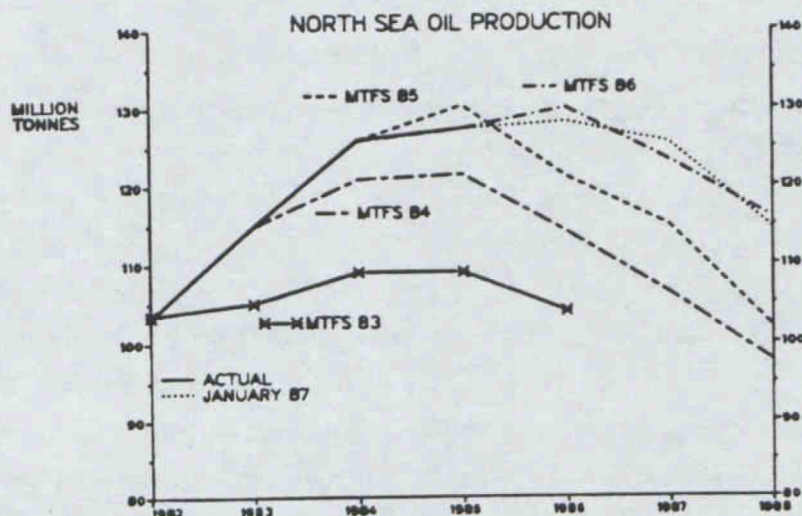
TABLE E1: NORTH SEA OIL PRICES, OUTPUT AND INVESTMENT

	World oil price* \$/barrel	N.Sea price \$/barrel	Crude and NGL output mn. tonnes	Brown Book range mn. tonnes	Gross fixed investment 1980 prices % change
1985	26.9	27.4	127.4	-	-15.7
1986	14.6	14.2	128.3	120-135	-16.0
1987	15.5	15.9	125.6	110-130	-13.4
1988	15.8	16.4	114.6	100-125	-6.7

\* OECD average fob import price.

### Production

78. North Sea oil and NGL production is now expected to decline only moderately in 1987 from last year's average level. This is rather better than assumed in the Autumn Statement reflecting more recent information. The latest path is still close to the centre of the 1986 Brown Book ranges.

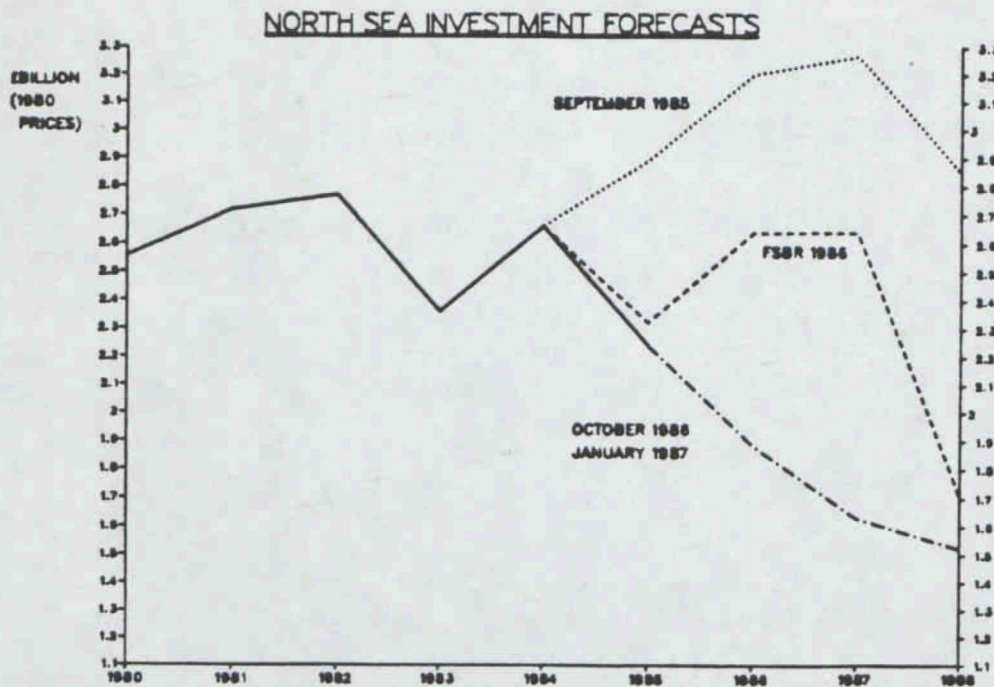


### Capital Expenditure

79. The value of capital spending in the North Sea now seems likely to have fallen by about 16 per cent in real terms in 1986. The NEDO investment intentions survey - on which the forecast is based - suggests further declines in 1987 and 1988, although gas investment may recover in later years. North Sea investment in current prices, crucial for the forecast of government revenues, will be held down not



only by the fall in volume, but also by cost reductions. North Sea investment prices are forecast to rise about 5 per cent a year less quickly than other investment prices in 1986 and 1987, and 2-3 per cent less in 1988.



### Government Revenues

80. Government revenues from the North Sea in 1986-87 are now expected to be £4.9 billion - about £1.2 billion below the 1986 FSBR forecast. The lower outturn reflects both lower than expected production in 1986 and lower prices in mid-year, as well as the APRT changes announced in the Autumn Statement. Revenues in 1987-88 are expected to fall further reflecting lower output and the full effect of the 1986 price fall in corporation tax, partly offset by firmer oil prices in the first half of 1987.

TABLE E2: GOVERNMENT REVENUES FROM THE NORTH SEA  
(£ billion)

	FSBR	Autumn Statement	January 1987
1985-86	11.5	11.3	11.3
1986-87	6.1	4.7	4.9
1987-88	4.0	4.3	4.5
1988-89	4.2	4.1	3.8

Oil in the balance of payments

81. The oil trade surplus fell to £4 billion in 1986 compared to £9 billion in 1985 (after allowing for coal strike effects). This more than offset lower payments abroad by North Sea companies. The trade surplus should decline more gradually in 1987 as firmer prices offset at least partly lower production but may fall again more quickly in 1988 as both production and prices fall.

**TABLE E3: OIL TRADE AND NORTH SEA IPD**  
(£ billion)

	Visible trade	N Sea IPD debits
1985	9.2*	- 3.6
1986	4.2	- 1.2
1987	3.8	- 1.4
1988	2.9	- 1.2

\* Adjusted for coal strike

**F: TRADE AND THE CURRENT BALANCE OF PAYMENTS**Recent performance and the forecast

82. The current balance which moved from surplus to deficit between the two halves of 1986, seems likely to show a very small deficit for the year as a whole, compared to a £3½ billion surplus in 1985. The fall in the oil surplus has coincided with a widening deficit on manufactures. These together have more than offset an increased invisibles surplus. (See table A4.)

83. The oil surplus which fell from £8 b. in 1985 to £4 b. in 1986 as a result of the decline in oil prices early in the year, has been broadly flat at its lower level in recent quarters as firmer prices have offset some worsening in the volume balance. The deficit in manufactures which narrowed temporarily in 1985, widened again in the second half of 1986 to about £6 b. for the year as a whole as rising import volumes more than offset a recovery in exports. The trade deficit in non-manufactures (other than oil) showed little change as export volumes grew more rapidly than imports, offsetting a decline in the terms of trade.

84. The improvement in the surplus on invisibles from £5.7 b. in 1985 to £8.6 billion in 1986 reflects almost entirely an increase in the net surplus on interest, profits and dividends. The sterling value of receipts rose as a result of the lower exchange rate and higher stock of net assets, while payments abroad from the North Sea declined as a result of lower oil prices. The surplus on services, which fell earlier in 1986 as a result of lower tourism net receipts, recovered later as other earnings rose. Payments to the EC were temporarily low.

TABLE F2: FORECAST CURRENT BALANCE

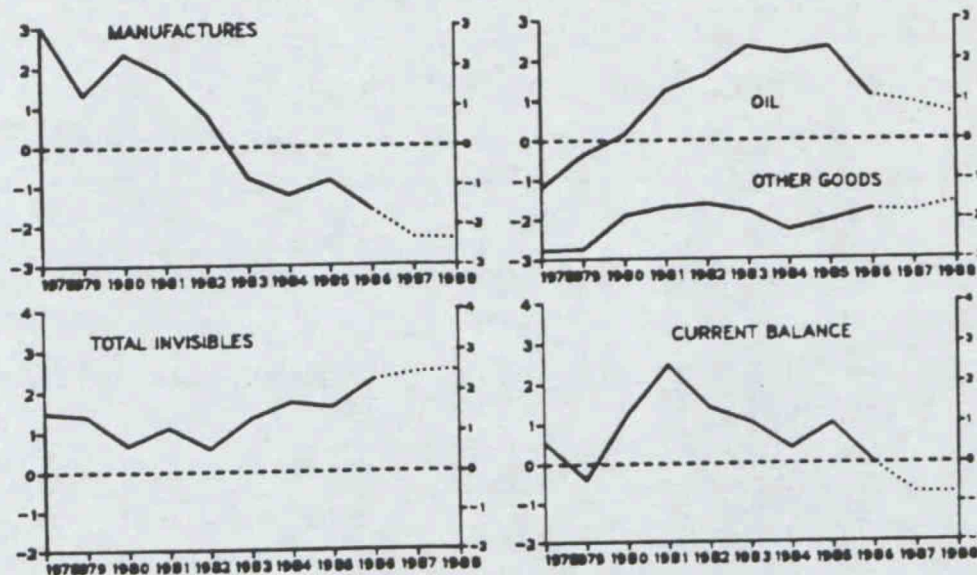
(£ billion)

	Oil trade	Manufactures	Other goods	Invisibles	Current balance
1986	4.2	-6.1	-6.7	8.6	0.1
1987	3.8	-9.5	-7.4	9.9	-3.1
1988	2.9	-10.4	-6.9	10.9	-3.5

85. The current account deficit, which was nearly £2 b. at an annual rate in the second half of 1986, seems likely to widen in 1987 before levelling off in 1988. The oil trade surplus, which may be slightly firmer in the months immediately ahead as a result of the recent rise in prices, seems likely to fall again subsequently as North Sea production declines. The deficit in manufactures seems likely to widen further as growth of domestic demand in the UK relative to the growth of potential output remains higher than in the rest of the G7 as a whole. The benefits of improved competitiveness will probably not be sufficiently strong during 1987 to prevent this increase in the current account deficit from its recent level. The non-manufactures deficit may rise a little in 1987 but the deficit should narrow in 1988.

86. The surplus on invisibles is likely to increase gradually over the forecast largely as a result of an improved services surplus. The surplus on net interest, profits and dividends may increase less rapidly than in recent years. Sterling's projected depreciation, coupled with assumed foreign stock market rises, will increase the value of the UK's foreign currency assets and receipts, but the forecast current deficit will also increase liabilities and payments. The cost of EC transfers will probably rise again in 1987, but payments fall again temporarily in 1988.

## Trade and invisibles balances as shares of GDP

Trade in Manufactures

87. Erratic monthly figures make it difficult to determine the underlying trend of either exports and imports of manufactures in the face of changing trends in world trade and domestic demand.

**TABLE F3: TRADE IN MANUFACTURES**  
(percent change on previous year)

	Main manufacturing countries exports+	UK export volume* of manufactures	Domestic demand for manufactures	UK import volume*	Term of trade for manufactures**
1985	4.2	8.4	4.2	5.3	1.4
1986	1.7	1.1	1.7	6.2	-1.0
1987	3.6	7.4	7.0	11.4	-1.0
1988	4.1	4.3	3.3	4.0	-0.1

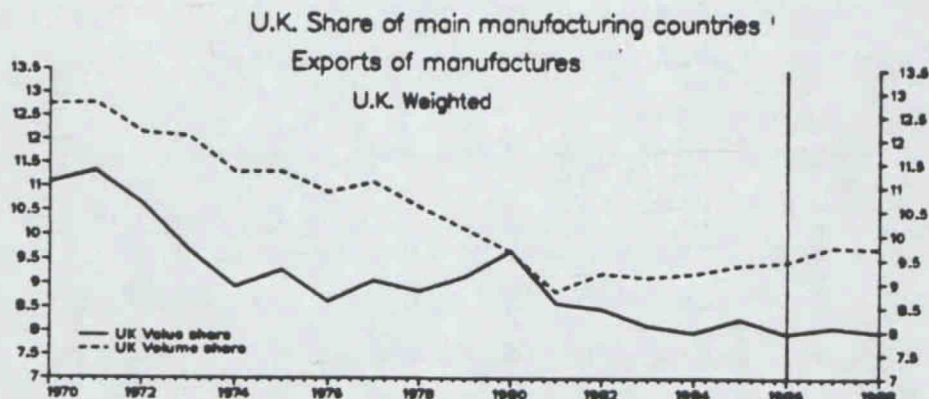
+ UK weighted

\* Excluding erratics

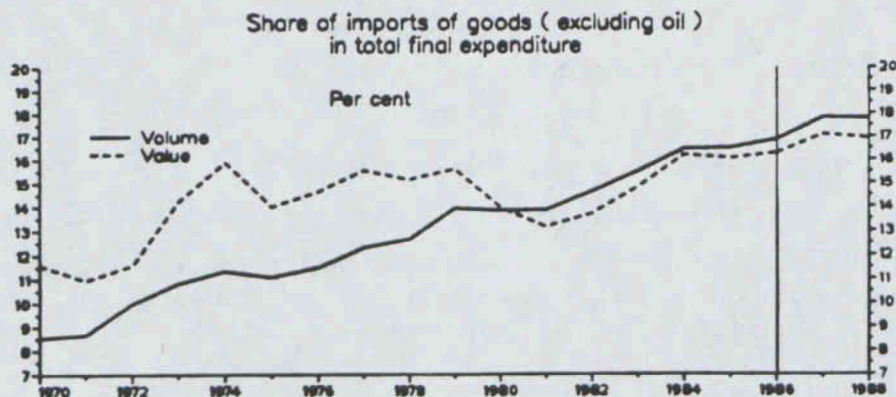
\*\*Average values

88. The volume of exports of manufactures (excluding erratics) appears to have risen by some 6 per cent in the second half of 1986 after falling in the early months of the year. The recovery of UK exports is rather stronger than the apparent upturn in main manufacturing countries' overall exports - although estimates of world trade in the

second half of 1986 are incomplete. The forecast assumes that UK exports will grow slightly more rapidly than those of other main manufacturing countries reflecting the improvement in UK competitiveness and continuing the UK's better trade performance of the early 1980s.



89. The apparent steep increase in domestic demand for manufactures in the second half of 1986 has been accompanied by an even more rapid rise in the volume of manufactured imports which are estimated to have been 11 per cent higher than in the first half year. The growth of imports seems likely to continue to be relatively rapid during 1987 given the projected rise in domestic demand, before tailing off in 1988 as domestic demand slows and the benefits of improved competitiveness are built up. Import penetration continues to rise - albeit considerably less rapidly than the experience of the 1970s would have suggested and at a rate more consistent with the better trading performance of the early - 1980s.



90. The margins of error in the forecasts for both manufactured export and import volumes are perhaps particularly large at present in

view of the uncertainties not only about the latest trends in trade volumes and in activity at home and abroad, but also about the impact of competitiveness. The judgement in this forecast is that the improved performance of recent years will continue. On the other hand if the projected rise in UK capacity utilisation hampers the ability of domestic producers to take advantage of the opportunities to increase exports and import substitutes, then the deterioration in performance on trade volumes could be worse than forecast.

91. The terms of trade for manufactures, which have been broadly constant since 1980, deteriorated during 1986 as sterling depreciated. The forecast has the terms of trade broadly flat as domestic producers take advantage of the depreciation of sterling to increase profit margins and foreign exporters to the UK are forced by competition from import substitutes to trim their margins.

#### Trade in non-manufactures (excluding oil)

92. Volumes of non-manufactured export rose unusually rapidly in 1986, partly as a result of abnormally high agricultural exports reflecting a large harvest and the distortions of the CAP which have made the UK the world's sixth largest gross cereals exporter. The forecast assumes that the volume of exports will return to more normal levels in early 1987 and then rise relatively rapidly - albeit not as quickly as in the recent past. Import volumes also rose strongly in 1986 as hard grain purchases increased exceptionally and imports of basic materials increased in line with rising domestic production and stockbuilding. Food imports should fall back to more normal levels this year, but growth of imports of basics could remain cyclically strong before easing later. The terms of trade in non-manufactures which have improved in recent years, are forecast to show a further rise in 1987 before levelling off in 1988.

**TABLE F4 : TRADE IN NON-MANUFACTURES (EXCLUDING OIL)**

(per cent change on previous year)

	UK agricultural output	Non-manufactures export volume	import volume	Terms of trade
1985	-3.7	1.3	0.9	3.7
1986	3.3	9.4	7.7	1.3
1987	-1.2	3.2	2.4	3.0
1988	-2.5	5.8	-0.9	-0.2

Invisibles

93. The volume of exports of services which fell in early 1986 - largely as a result of fewer US tourists - appears to have recovered later in the year, helped by buoyant earnings from financial services. The outturn for the year as a whole was probably little changed from 1985. Exports are forecast to continue to grow healthily, reflecting higher world activity and improved competitiveness. Import volumes rose in 1986 largely as a result of increased travel spending. A further strong rise seems likely in 1987 in line with rising real incomes but better competitiveness should restrain growth thereafter. The projected depreciation of sterling implies a further decline in the services terms of trade in line with past experience.

**TABLE F6 : TRADE IN SERVICES**  
(per cent change on previous year)

	Export volume	Import volume	Terms of trade	Services balance £ billion
1985	7.7	2.0	2.4	5.8
1986	-0.1	1.6	0.9	5.8
1987	5.1	3.0	-2.0	6.4
1988	4.6	3.1	-0.9	7.1

94. The net surplus on interest, profits and dividends rose sharply in 1986 and seems likely to rise further over the forecast period - albeit less rapidly as the cost of financing the current deficit rises. Payments abroad by North Sea oil companies which fell steeply in 1986 with lower oil prices, seem likely to continue on a declining path in future as oil production falls. Net credits on other oil investments, however, seem likely to recover from their low 1986 level. Net earnings from direct investment should also rise. Other net receipts, however, may show little overall increase as the benefits from rising overseas assets and sterling's depreciation are offset by increasing liabilities to finance the current deficit.

## SECRET

TABLE F7 : INTEREST, PROFITS AND DIVIDENDS BALANCE  
(£ billion)

	N.Sea Oil	Other Oil	Direct investment	Other	Total IPD
1985	-3.6	1.9	2.1	3.0	3.4
1986	-1.2	0.6	2.4	3.5	5.2
1987	-1.4	1.1	2.6	4.6	7.0
1988	-1.2	1.3	2.6	4.2	6.9

95. The net transfers deficit, which fell in 1986 largely as a result of abnormally high EC receipts partly delayed from 1985, should return to more normal levels this year but fall again temporarily in 1988.

TABLE F8 : TRANSFERS BALANCE

	EC transfers	Other	Total
1985	-2.1	-1.4	-3.5
1986	-0.8	-1.6	-2.4
1987	-1.5	-2.0	-3.5
1988	-1.0	-2.1	-3.1

### G: INFLATION

96. There have been some signs of the trend in inflation edging up slightly in recent months following the fall in sterling and slight pick up in commodity prices during the latter part of the summer. The outturns for both wholesale and retail prices in 1986Q4 were a little higher than expected at the time of the Autumn Statement. The November and December CBI surveys indicated a small upward underlying movement in the proportion of respondents expecting to raise prices in the near future. The forecast for retail price inflation has been shaded up during 1987 to just under 4½ per cent at the end of the year (just under 4 per cent excluding mortgage interest payments). Inflation may rise a little further during 1988, and is expected to remain higher than in other major industrial countries.



TABLE G1: SUMMARY OF INFLATION PROSPECTS

	Consumer (retail) prices			
	1985	1986	1987	1988
UK	6.1	3.4	4.7	4.6
(excluding mortgage interest payments)	(5.2)	(3.6)	(4.0)	(4.2)
G7 less UK	3.7	1.8	2.2	3.1
	Producer (wholesale) output prices			
UK	6.3	4.3	4.3	4.1
G7 less UK	1.8	-3.2	0.8	2.6
	Average earnings			
UK	7.7	7.5	7.3	7.1
G7 less UK	4.9	3.3	3.4	4.3
	Manufacturing unit labour costs			
UK	4.3	4.9	1.7	2.2
G7 less UK	1.2	0.8	0.2	1.1

Producer Prices

97. The deceleration in producer output prices experienced in 1986 was much less marked than the deceleration in costs, implying a substantial rise in margins in manufacturing industry. Although materials costs have been rising in recent months only a small rise is expected in 1987 as a whole. In addition, the fast productivity growth forecast for 1987 will hold down the growth in manufacturing industry's costs in total. Profit margins are likely to rise further, as producers do not normally pass on all the benefits of higher utilisation of labour in lower prices. On the assumption of little change in the exchange rate during 1987 price inflation over the year as a whole is likely to be a similar to the 1986 rate. With a renewed fall in the exchange rate thereafter, and some recovery in world commodity prices, producer price inflation is expected to rise in 1988.

TABLE G2: MANUFACTURING COSTS AND PRICES

percentage change on a year earlier

	Unit Labour Costs	Cost of Materials and Fuels	Estimated total Costs	Domestic Producer Output Prices	Finished Manufactures Import Prices
1985 Q4	5.5	- 5.1	1.6	5.9	- 0.6
1986 Q4.	1.9	- 5.6	0.1	4.1	11.2
1987 Q4	2.7	0.5	2.9	4.2	2.6
1988 Q4	2.5	5.1	3.7	4.9	5.3

RPI

98. The expected monthly path of RPI inflation until early 1988 is given below; the hump in inflation during 1987 reflects in particular the pattern of mortgage interest rate changes during 1986 and, as discussed below, the trough in petrol prices during the summer of 1986.

TABLE G3: MONTHLY PATH OF RPI

		RPI	RPI			RPI	RPI
		excluding	excluding			excluding	excluding
		m.i.p.(1)	m.i.p			m.i.p	m.i.p
		and petrol	and petrol			and petrol	and petrol
	RPI				RPI		
1986 J				1987 J	4.0	3.8	4.5
F				F	4.1	3.9	4.3
M				M	4.4	4.2	4.4
A				A	4.6	4.2	4.1
M				M	4.8	4.4	4.0
J				J	5.3	4.4	4.1
J	2.4	3.2	4.4	J	5.3	4.4	4.1
A	2.4	3.3	4.5	A	5.3	4.4	3.9
S	3.0	3.4	4.4	S	5.0	4.1	3.8
O	3.0	3.4	4.2	O	4.9	4.0	3.9
N	3.5	3.3	4.1	N	4.3	3.9	3.8
D	3.7	3.5	4.3	D	4.1	3.8	3.7
				1988 J	4.0	3.7	3.8
				F	4.0	3.7	3.9
				M	3.9	3.6	3.8

(1) Mortgage interest payments.

99. Retail prices rose by 3.4 per cent in the year to 1986Q4, just above the Autumn Statement forecast. Although seasonal food prices in the fourth quarter were lower than expected, there was a marked pick-up in the prices of some durable goods and in motor insurance premiums.

100. The fall in world oil prices in 1986 will continue to feed through to the energy prices charged to UK domestic consumers during 1987. Domestic electricity prices are forecast to remain unchanged during 1987, while gas prices are expected to rise by only 0.5 per cent in May, and coal prices to rise by 2.8 per cent in November.

101. Non energy nationalised industry prices are expected to rise a little faster than inflation generally; the main price rises this year are:

British Rail	5.9 per cent in January 1987
London Regional Transport	4.5 per cent in January 1987
Water charges*	6.5 per cent in April 1987
Post Office*	1.5 per cent in October 1987

\* Forecast

102. Food price inflation should continue at a very moderate rate, reflecting the forecast continued weakness of world food prices. The green pound is assumed to depreciate by 6 per cent between 1986Q4 and 1987Q4. By the end of 1987 this will have added  $\frac{3}{4}$ -1 per cent to UK food prices, but with other world food prices falling in sterling terms the overall increase in the food component of the RPI over the period is expected to be only about  $2\frac{3}{4}$  per cent.

103. The housing component of the RPI will make a disproportionate contribution to inflation over the next year, even with no further rise in mortgage interest rates. (The November 1986 rise in interest rates will be adding to annual inflation until the end of the fourth quarter of 1987.) A rise of  $7\frac{1}{2}$  per cent in the index for domestic rates is expected in April 1987.

TABLE G4: MORTGAGE INTEREST RATES

	1986 FSBR forecast	Autumn Statement forecast	Current forecast
1986Q4	11.75	11.8	11.8
1987Q4	11.00	12.25	12.25
1988Q4	9.70	12.25	11.25

104. The evolution of petrol prices had a considerable impact on the path of inflation over the past twelve months. Over the year to 1987Q4 petrol prices are likely to rise at much the same rate as inflation generally (on the normal assumption of indexation of specific duties). However in the summer of 1987, when seasonal influences will tend to push up petrol prices, prices may rise to over 180p a gallon, about 15 per cent higher than the low point reached last summer, when the world oil price was very weak. This exacerbates the hump in the rate of RPI inflation during the summer of 1987. If the world price were to stay at \$18 a barrel throughout the year, for a given exchange rate petrol prices might be about 6p higher than forecast in the fourth quarter of 1987, adding directly between 0.1 and 0.2 per cent to the RPI.

105. Other private sector prices should reflect the moderate growth of producer prices expected over the next year. The total RPI should rise by 4.4 per cent over the year to 1987Q4, about a  $\frac{1}{2}$  point above the Autumn Statement forecast, and a little above the internal October forecast. With a renewed fall in the exchange rate at a time when world commodity prices may be making some modest recovery, the forecast is for the rate of RPI inflation to pick up further to around 5 per cent at the end of 1988.

TABLE G5: THE RPI

(Percentage changes on a year earlier)

	Autumn Statement forecast in brackets			
	1985 Q4	1986 Q4	1987 Q4	1988 Q4
Food prices	3.2	3.2 (4 )	2.8 ( 2 $\frac{1}{2}$ )	4.4
NI prices	5.7	3.6 (3 $\frac{1}{2}$ )	2.1 (1 $\frac{3}{4}$ )	4.4
Housing prices	9.3	7.1 (6 $\frac{1}{2}$ )	9.1 (10 $\frac{1}{4}$ )	7.7
Other prices	5.3	2.6 (2 $\frac{1}{4}$ )	4.1 ( 3 )	4.4
- of which petrol	1.6	-12.6	5.0	4.1
- other items	5.6	3.9	4.0	4.4
All items RPI	5.5	3.4 (3 $\frac{1}{4}$ )	4.4 ( 3 $\frac{3}{4}$ )	4.9
RPI excluding mortgage interest payments.	5.2	3.4	3.9	4.6

GDP deflator

106. The GDP deflator measures the price of UK value added, and has been depressed over the last year by the fall in North Sea oil profits. A forecast modest decline in growth of average earnings in 1987 and a deceleration of non-oil profits will help to bring down the growth of the non-oil GDP deflator a little; but the stabilisation of oil prices implies that the rate of increase of the GDP deflator will rise in 1987 and the forecast for whole economy wage costs implies that the GDP deflator is not likely to decline thereafter as in the 1986 MTFs path.

**TABLE G6: FORECASTS FOR THE MARKET PRICE GDP DEFLATOR**

	1984-85	1985-86	1986-87	1987-88	1988-89
<b>MTFS</b>	4.2	6.1	3.7	3.8	3.4
<b>January Forecast:</b>					
<b>total</b>	4.3	6.3	3.0	4.1	5.0
<b>non-oil</b>	3.6	8.0	5.8	4.0	4.8

Earnings

107. In the private sector the rate of settlements monitored by Department of Employment edged down slightly in the last pay round (from 6 per cent to  $5\frac{3}{4}$  per cent). The underlying rate of growth of private sector average earnings declined more than this (from  $8\frac{1}{2}$  to  $7\frac{3}{4}$  per cent) as overtime hours fell. Underlying earnings growth for the whole economy remained at  $7\frac{1}{2}$  per cent.

108. In the current pay round settlements have fallen further. Manufacturing settlements monitored by the Department of Employment in the current pay round have been 1 percentage point below the average rate of settlement in manufacturing in the previous pay round. The CBI's evidence suggests if anything a larger fall than this. The downward trend in pay settlements in manufacturing is partly attributable to the weakness of manufacturing output since the first half of 1985; it is not clear to what extent this trend also applies outside the manufacturing sector. Relatively few settlements outside manufacturing have been monitored by Department of Employment in this

pay round so far. Until recently these had not indicated much of a fall, but one recent large settlement at a low level has now been picked up. Taking account of this, settlements monitored by Department of Employment in the private sector as a whole have also declined by about 1 percentage point in the current pay round so far.

109. The forecast assumes that in the current pay round as a whole private sector settlements will fall by about 1 percentage point. The fall in earnings growth is slightly less than this as overtime is forecast to rise. The forecast of underlying growth in private sector earnings of about 7 per cent over the current pay round is roughly the same as in the internal October forecast. The circumstances for later pay rounds, with higher inflation and falling unemployment, are not propitious for further falls in earnings growth.

**TABLE G6: FACTORS AFFECTING PRIVATE SECTOR EARNINGS**

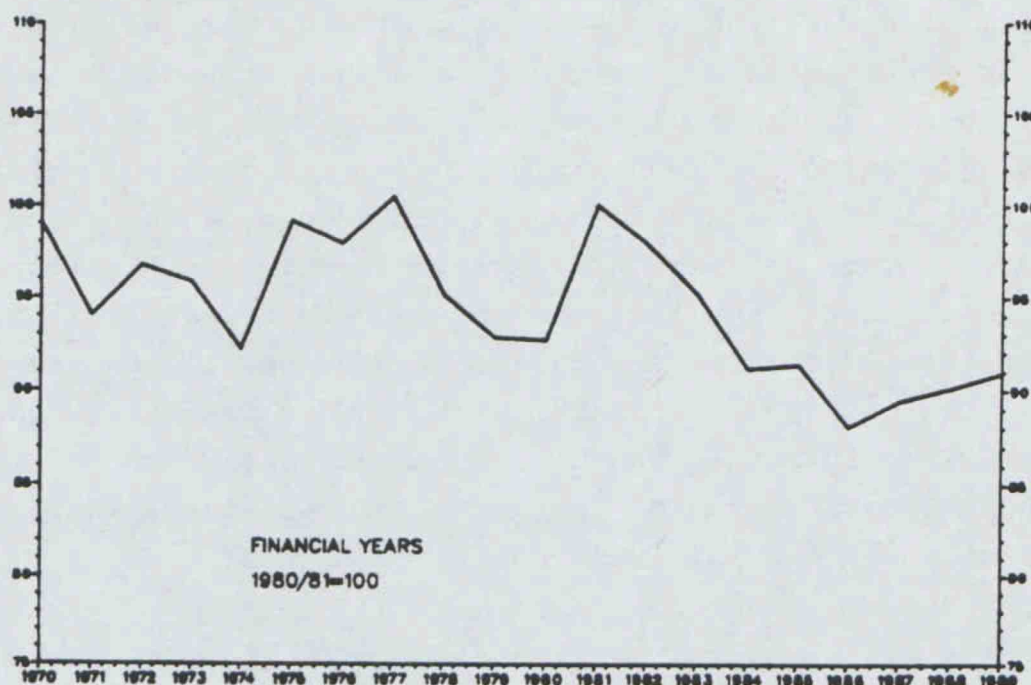
	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
	(figures in brackets are forecast)					
<b><u>RPI inflation</u></b>						
(i) At start of round, Q3	4.6	4.7	6.3	2.6	(5.2)	(4.8)
(ii) Outcome on inflation in round just starting, Q3	4.7	6.3	2.6	(5.2)	(4.8)	(5.0)
<b><u>Unemployment Rate</u></b>						
Level at start of round	10.9	11.1	11.3	11.5	(10.4)	(10.1)
<b><u>Real take home pay</u></b>						
(per cent, second half of year on second half)	4.2	1.4	3.4	4.1	(3.0)	(2.4)
<b><u>Profit Share</u></b>						
per cent (Non North Sea ICCs)	7.7	8.8	10.4	11.0	(11.0)	(11.3)
<b><u>Underlying Earnings Growth</u></b>						
per cent change on a year earlier	7.8	8.6	7.8	6.9	7.0	7.0

110. Settlements in public services in the 1985-86 pay round were higher on average than settlements in the private sector, but higher drift in the private sector meant that earnings growth in public services was again lower (just) than in the private sector. In this forecast public service pay grows in line with private sector pay, except for an allowance made for the faster growth of teachers' pay, and (in the current pay round) the effect of staging some central government pay awards in 1986, which adds to annual earnings growth in 1987.

TABLE G8: UNDERLYING EARNINGS GROWTH BY PAY ROUND AND SECTOR

	Private Sector	Public Services	Public Trading
1985-86	7 <sup>3</sup> / <sub>4</sub>	7½	8½
1986-87	7	7½	7
1987-88	7	8½	7
1988-89	7	7½	7

RATIO OF PUBLIC SECTOR TO PRIVATE SECTOR AVERAGE EARNINGS.



**H: PERSONAL AND COMPANY INCOME AND SPENDING****1. The Personal Sector****Consumers' expenditure and saving**

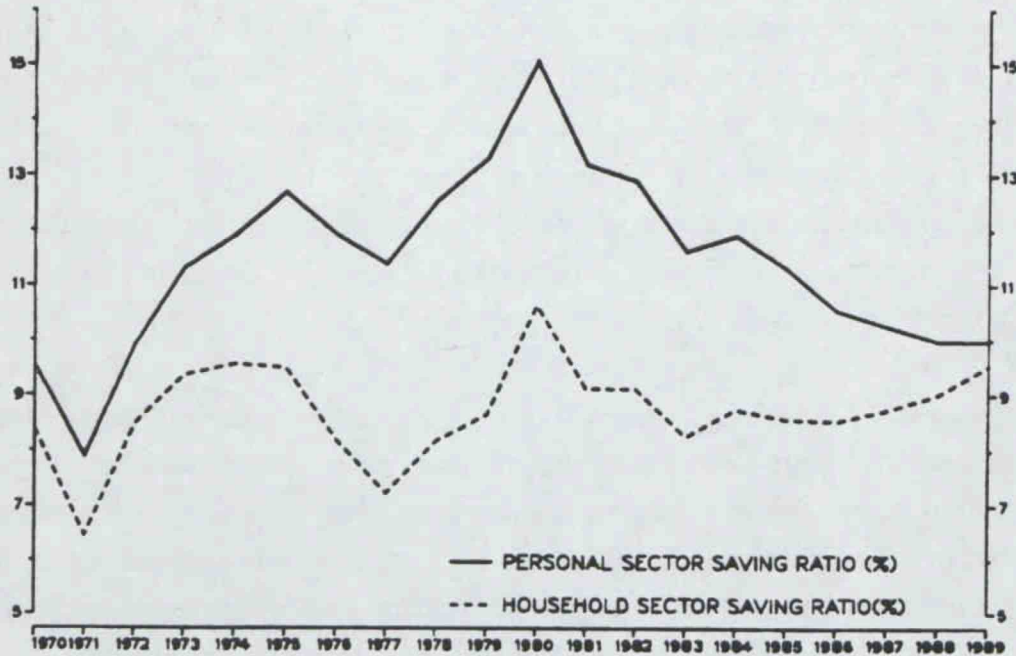
111. Currently available data shows that consumers' expenditure rose by almost 5 per cent in 1986 against a 4 per cent rise in real personal disposable income. It is unusual for the saving ratio to fall in the way these figures imply during a period of strong income growth. Part of the explanation is the fall in inflation; but there seems to be more to it than this. The ready supply of credit may have had an impact on spending, although the expansion of credit in 1986 was not markedly greater than in earlier years, when fast growth of credit was not associated with unusually low saving. The main explanation for this fall in the personal saving ratio probably lies elsewhere.

112. One factor tending to depress the personal saving ratio in the recent past is the slow growth of employers' pension contributions in the face of the surpluses that pension funds have built up in recent years. Employers' contributions count as personal disposable income; so that, for a given amount of spending by persons, lower employers' contributions mean lower recorded personal saving. An alternative measure of disposable income, approximating more closely to the purchasing power of the household sector, is found by excluding incomes accruing to pension funds and including pension benefits received by households. This shows a stable saving ratio over the last year and a generally higher level of saving in recent years relative to saving rates in the 1970s than is suggested by the normal measure of personal saving. The slight forecast pick up in inflation and the rise in interest rates last autumn will probably lead to a rise in the "household" saving ratio during 1987 and 1988, while the personal saving ratio may show a further small fall.



**PERSONAL AND HOUSEHOLD SAVING RATIOS**

(NOT INFLATION ADJUSTED)



The forecast has the following annual reductions in income tax, over and above indexation of allowances.

1987-88	£3.0 billion
1988-89	£1.9 billion

The cut in tax assumed for the next Budget, worth just over 1 per cent on personal disposable income, should keep consumer spending growing rapidly for another year. Tax cuts assumed for later years are insufficient to offset real fiscal drag, and the rate of growth of consumer spending moderates.

TABLE H1: CONSUMER SPENDING

	RPDI	Consumers Expenditure (percent changes on a year earlier)			Personal Saving Ratio (%)
		Non-durables	Durables	Total	
1985	3.0	3.2	7.4	3.7	11.3
1986	3.9	4.2	10.1	4.9	10.5
1987	3.1	3.0	5.8	3.4	10.3
1988	2.5	2.7	3.5	2.8	10.0

The Housing Market

113. The buoyancy of personal incomes has been an important factor behind the more rapid growth of house prices since mid 1985. Net mortgage advances were running at very high levels during the middle of 1986, but the main part of the increase in advances seems to have come after the acceleration in house prices got underway. It was in part the pick up in prices and the expectations of further price rises that created the conditions which enabled the lending institutions to increase their business.

114 Private housing starts have been rising since early 1985 and totalled around 175,000 in 1986, an 8 per cent increase on the previous year. Completions have as usual lagged behind starts, but should have reached a total of around 160,000 in 1986. The completion of houses now under construction should mean strong growth in private residential investment in 1987. Builders are likely to become increasingly cautious about expanding further the scale of their activities in the light of the rise in interest rates in November 1986 and some speculation about an absolute fall in house prices. This could mean little further rise in housing investment in 1988.

**Personal Sector: Summary**

115. Table H2 summarises the forecast for personal income and spending.

**TABLE H2: PERSONAL INCOME AND SPENDING**

(percent changes on a year earlier)

	RPDI	Consumers' expenditure	Investment in dwellings	Persons net acquisitions of financial assets (£bn)
1985	3.0	3.7	-3.0	10.1
1986	3.9	4.9	8.7	8.1
1987	3.1	3.4	10.1	7.0
1988	2.5	2.8	2.8	5.9

## 2. Company Income and Spending

116. Industrial and commercial companies' profits net of stock appreciation are recorded as having fallen by £4 billion (9 per cent) between the first three quarters of 1985 and the first three quarters of 1986: profits of North Sea Oil companies fell by almost £8 billion and profits of other companies rose by about £4 billion. If the figures are to be believed the recent growth recorded in non-oil companies' profits has been disappointing by the standards of the previous two years, particularly in view of the benefits these companies have enjoyed from low oil and other commodity prices. We strongly suspect, however, that the published data is currently understating the recent growth in profits, and the tax forecast makes allowance for some such understatement in the recent figures and has carried forward this allowance to later years as well. Table H3 shows the rates of return and profit shares on the basis of published figures, and on the the basis of the adjusted figures that have been used for the tax forecast.

TABLE H3: INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits* as a share of total income (per cent)		Rate of return on assets*, non-oil ICC's (per cent)
	Oil	Non-oil**	
1973-84 average	2.9	10.5	5.5
1985	6.0	12.2 (12.5)	7.7
1986	2.5	13.2 (13.6)	8.4
1987	2.4	12.9 (13.4)	8.1
1988	2.0	13.2 (13.7)	8.4

\* Net of stock appreciation and adjusted for privatisation

\*\* Figures in brackets are adjusted for assumed under-recording of profits in the published national accounts statistics.

117. The forecast of little change in non-oil companies rate of return over the next two years contrasts markedly with recent years up to 1985 (and probably also with 1986, if our suspicions about the data are correct). Since 1981 companies' profits have been boosted first by exceptional productivity growth in the early stages of the recovery and more recently by very favourable movements in the commodity terms of trade. The forecast period has productivity growth some way above the levels of the 1970s - though below the peak of the 1981-83 period, and at the same time some recovery in world commodity prices. While the environment for the company sector is not a particularly difficult one, it may not have much opportunity for substantial further improvements in its financial position over the next few years. This implies slower growth than recently in the corporate tax base.

**TABLE H4: COMPANIES' NET INCOME\***

(adjusted for privatisation, percentage changes on previous year)

	<b>Non North Sea ICCs</b>	<b>Financial companies</b>
1984	24 (24)	19
1985	7 (10)	23
1986	14 (16)	8
1987	7 ( 7)	12
1988	11 (11)	8

\* Net income approximates companies' tax base: for ICCs it is defined as gross profits minus short-term interest payments; for financial companies it is trading income plus income from abroad less short-term interest payments. Figures in brackets are after adjustment for assumed under-recording in the published statistics.

118. The forecast flattening out of profitability, combined with the recent surge in tax payments, a prospective pick up in fixed investment, and probably also some tendency for more stable stock output ratios, means that companies' expenditure should rise relative to income, and ICCs borrowing requirement will be significantly higher than it has been in recent years.

TABLE H5: ICCs' FINANCIAL SURPLUS AND BORROWING REQUIREMENT

	ICCs		Borrowing Requirement (£bn)	Non-oil ICCs	
	NAFA (£bn) (% of GDP)			NAFA (£bn) (% of GDP)	
1973-84 average	1.7	0.5	3.3	1.9	0.8
1985	6.6	1.9	4.8	6.3	1.8
1986	4.1	1.0	3.8	7.2	1.9
1987	3.4	0.8	10.0	3.1	0.8
1988	3.3	0.8	10.1	3.6	0.8

ICCs financial state of health is now very sound and they should be able to live with the projected rise their in borrowing requirement, particularly if, as forecast, they continue to raise substantial amounts of finance on the capital markets. Holdings of liquid assets, net of bank lending, should remain at levels which companies have apparently found acceptable in the past, while gross holdings of liquid assets will remain close to record levels in relation to the scale of their activities.

#### Business Investment

119. Figures published for the first three quarters of 1986 suggest that manufacturing investment is likely to show a fall for the year as a whole, while non-oil business investment will be at best flat. These results are well below what had been suggested by the DTI's June Intentions Survey. As with company income there are grounds for being suspicious of the data. Early estimates of investment are based on relatively poor information and often subject to substantial revision.

120. The latest Intentions Enquiry suggests a fairly large rise in non-manufacturing investment (in distribution in particular) in 1987, although relatively little recovery in manufacturing investment is likely. The DTI's projections of manufacturing investment for 1987 seem broadly consistent with the CBI's Survey results and are close to the CBI's latest staff forecast. Manufacturers' investment plans do not as yet appear to be reflecting the pick up in output during 1986. 1988 should show a stronger investment performance in manufacturing, and it remains a possibility that plans for 1987 will be revised up.

**TABLE H6: REAL FIXED INVESTMENT**  
(percentage change on previous year)

	1985	1986	1987	1988
<b><u>Manufacturing*</u></b>				
December DTI Survey	5.6	-2.4	2.3	5.0
HMT January forecast	5.6	-2.4	3.0	5.9
<b><u>Non-oil, non-manufacturing*</u></b>				
December DTI Survey	8.0	-0.3	8.3	6.0
HMT January forecast	8.0	-0.3	8.3	5.6

\* Manufacturing includes leased assets; non-manufacturing excludes assets leased to manufactures and is adjusted for the estimated effect of privatisation.

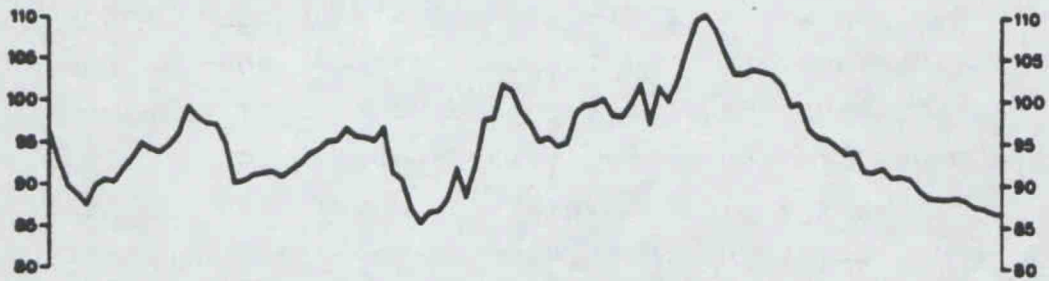
**Stockbuilding**

121. Stock output ratios continued to fall during 1986. One special factor in 1986 was exceptional sales of agricultural produce out of Intervention Board stocks to drought-affected countries in southern Europe: we do not expect these sales to continue in 1987. We also expect that manufacturers and distributors' stock ratios may fall less steeply as much of the adjustment to earlier rises in the cost of stockholding has now taken place. Thus stockbuilding is likely to make a positive contribution to growth in 1987, though probably not a large contribution.

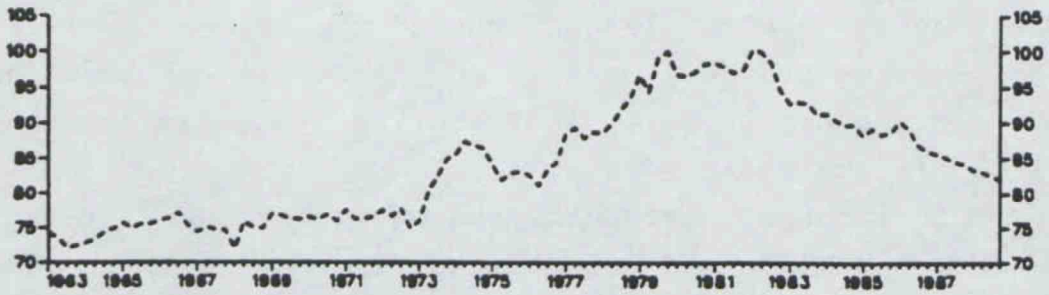
### AGGREGATE STOCK RATIOS

(1979Q4=100)

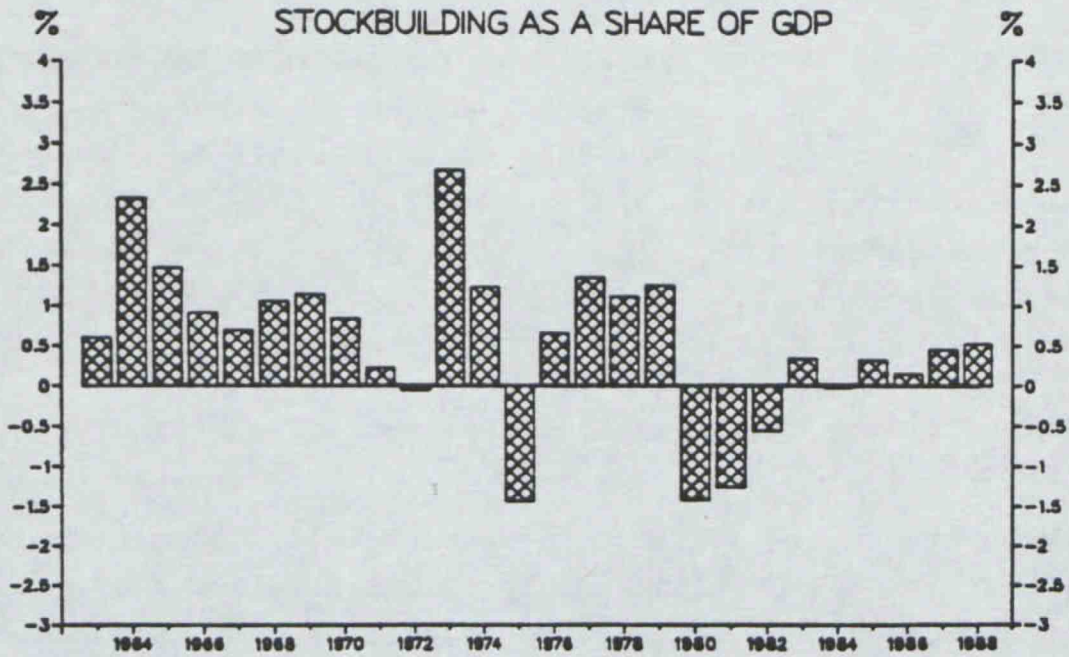
MANUFACTURERS STOCK OUTPUT RATIO



DISTRIBUTORS STOCK SALES RATIO



STOCKBUILDING AS A SHARE OF GDP



## I. PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

122. The slowdown in output growth from around 4 per cent in the year to the first half of 1985 around to 2 per cent over the following year was accompanied by a corresponding slowdown in productivity growth. Apart from the recovery from the coal strike, non-oil productivity was hardly more than 1 per cent up on a year earlier in the first half of 1986, and manufacturing productivity hardly rose at all over this period. More recently, however, productivity has been rising quite rapidly. Manufacturing productivity in the three months to November was  $4\frac{1}{2}$  per cent higher than a year earlier.

123. The results from the 1984 Census of Employment involve effectively no change to the previous estimates of whole economy productivity growth for recent years. Manufacturing productivity growth has been about  $\frac{3}{4}$  per cent a year faster since 1981 than previously thought, and non-manufacturing productivity growth slower. The productivity record since the 1960s and our forecast is summarised in table II.

**TABLE II: OUTPUT PER HEAD OF THE EMPLOYED LABOUR FORCE**

	Annual averages, percentage changes			
	1964-73	1973-79	1979-86	1986-88
Manufacturing	$3\frac{3}{4}$	$\frac{3}{4}$	$3\frac{1}{2}$	$4\frac{1}{2}$
Non-manufacturing*	3	$\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$
Non-oil economy	$2\frac{3}{4}$	$\frac{1}{2}$	$1\frac{3}{4}$	2
Whole economy	$2\frac{3}{4}$	1	2	$1\frac{1}{2}$

\* Includes private sector and nationalised industries other than in manufacturing and oil.

The strong growth of manufacturing productivity forecast over the next two years is in part the result of relatively strong output growth; non-manufacturing productivity growth will be depressed to some extent by the effect of SEMs and the restructuring of NICs, though it is still forecast to be higher than in 1970's and above the average for the first half of the 1980's.



124. The employed labour force grew only slowly during the first half of 1986, but more recent figures suggest that growth in employment is now picking up again: employment grew by 71,000 during 1986Q3, and the latest few months show a slackening of the fall in manufacturing employment. The forecast has strong employment growth over the next two years, with roughly  $\frac{3}{4}$  million extra jobs between June 1986 and the end of 1988.

125. The OPCS have recently published revised population projections, and the Department of Employment have made consequent revisions to their labour force projections. (They will not be publishing revised labour force projections until the spring.) Net migration flows have changed markedly in recent years with net outflows in earlier years turning into net inflows of around 50,000 a year since mid-1983. The OPCS are now assuming inflows continuing at around 50,000 a year until mid-1987, and zero net flows thereafter. Important factors behind the change in migration patterns include the social unrest in South Africa and the improvement in the UK's relative economic performance, and these factors could continue to influence migration trends after 1987. Because the OPCS population projections are probably too low, and also because it is likely that female activity rates will rise more quickly than allowed for by Department of Employment the forecast uses labour force projections that are higher than Department of Employment's revised estimates. However, labour force growth still falls over the next few years.

**TABLE 12: PROJECTIONS OF LABOUR SUPPLY GROWTH**

(000s)

Mid-year	GB DEmp Gazette July 1985	GB DEmp Revised estimate*	UK January Overview
1985 to 1986	179	257	295
1986 to 1987	160	185	220
1987 to 1988	103	125	172

\* unpublished and subject to revision before publication

126. The labour supply and productivity forecasts together imply non-oil productive potential growing by about  $2\frac{3}{4}$  per cent a year over the next two years. For the whole economy, after taking account of the forecast decline in North Sea output, productive potential may grow at an annual rate of around  $2\frac{1}{4}$  per cent.

**TABLE 13: PRODUCTIVE POTENTIAL**

Annual averages; percent changes

	Non-oil trend productivity growth	Labour supply	Non-oil productive potential	Contribution and North Sea	Whole economy productive potential
1973-79	1.0	$\frac{1}{2}$	$1\frac{1}{2}$	$\frac{1}{2}$	2
1979-86	$1\frac{3}{4}$	$\frac{1}{2}$	$2\frac{1}{4}$	$\frac{1}{4}$	$2\frac{1}{2}$
1986-88	2	$\frac{3}{4}$	$2\frac{3}{4}$	$-\frac{1}{2}$	$2\frac{1}{4}$

127. Unemployment has been falling since August, and should continue falling quite rapidly over the next few months as output grows strongly, the effects of the Restart programme build up and the new availability test begins to have an impact. The forecast makes allowance for the package of further measures which Lord Young is likely to announce shortly and which may reduce the unemployment count by a little under 100,000 over the next year.

**TABLE 14: CHANGES IN ADULT UNEMPLOYMENT**

(seasonally adjusted 000s)

	Unemployment	SEMS*	12 Month Restart and Availability Testing	Underlying Unemployment
1985(2)-1986(2)	89	-71	0	160
1986(2)-1987(2)	- 205	-78	-111	- 16
1987(2)-1988(2)	- 152	-115	25	- 62

\* including the new package of measures to be announced shortly

**J. AGGREGATE DEMAND AND OUTPUT**

128. Interpretation of the path of the economy over the last year is made difficult by large discrepancies between the income, expenditure and output-based measures of GDP. The output measure is showing growth of almost 3½ per cent in the year to 1986 Q3; the income and expenditure measures are indicating growth of about 1½ per cent. In the past, early estimates of the output measure have proved a much more reliable guide to movements in economic activity than have the other measures. Research results published in 1984 by the National Institute confirmed that in the past preliminary output based growth estimates have been clearly superior to preliminary average estimates as predictors of the figures for growth that the CSO eventually show. On this occasion the behaviour of the output measure seems to be much more in line with various indicators of economic activity, such as unemployment, vacancies, overtime hours, tax revenues, and imports. There is little reason, therefore, to give any weight to the expenditure or income estimates for the recent past.

129. For the purpose of the estimates of real and money GDP in this forecast, the numbers published by the CSO for the average measure of GDP over the last year have been overridden. GDP(A) has been projected as growing in line with the output based estimate of GDP from 1985(3). The estimate for real and money GDP growth in 1986 are thus significantly higher than what would be obtained if the published estimates for GDP(A) were used without adjustment. The likelihood is that the published figures will eventually be revised to show still higher growth than the adjusted figures show.

130. 1987 should see a continuation of the strong growth in the non-oil economy that has been experienced since the early part of 1986. The main motive force will be private investment both residential investment and business investment will show a strong recovery (even though oil investment will continue to fall and manufacturing investment is likely to be relatively static). 1988 also sees an important cyclical contribution from business investment; meanwhile in 1987 and 1988 consumers' expenditure tends to decelerate, as the

forecast tax cuts in both years are not sufficient to sustain real income growth in the face of the mild pick up of inflation. While GDP growth overall tends to slow down during 1988 as a result of the assumed tightening of fiscal policy and the rise in interest rates, growth of non-oil GDP is nevertheless close to 3 per cent for the year as a whole.

131. The path of oil output over the immediate future has been revised upwards since the Autumn: it is now expected to fall by only just over 1 per cent in 1987, but much more steeply than this in 1988.

132. Most of the growth in output over the last year has taken place outside the manufacturing sector of the economy. Private sector output outside the manufacturing and oil sectors has risen by around 4½ per cent over the last year, including a 6 per cent increase in construction output. The benefit to the manufacturing sector flowing from the gain in competitiveness during 1986 and the forecast shift in the composition of domestic demand away from consumers' spending to investment suggest that growth in 1987 and 1988 will be less weighted toward the non-manufacturing sector of the economy.

**TABLE J1: EXPENDITURE AND OUTPUT**  
percentage changes on a year earlier

	1985	1986	1987	1988
Domestic demand	2.9	3.3	3.4	2.6
Exports of goods and services	5.9	2.7	4.3	1.8
Imports of goods and services	3.0	5.6	7.4	2.2
Compromise adjustment*	-0.4	0.7	0.7	0
GDP(A)	3.7	3.0	3.1	2.5
Non-oil GDP(O)	3.9	2.8	3.6	3.4
Manufacturing output	3.1	0.4	3.1	3.3

\* Contribution to growth, includes adjustments to published data discussed in text.

## ANNEX A:

## PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure for 1986-87 takes account of the latest information available, including GEP's monthly assessments. For 1987-88 onwards, the forecast reflects the extent to which the plans in the 1987 Public Expenditure White Paper are likely to be achieved given the forecast's assessment of economic developments and other pressures on expenditure.

2. Detailed assumptions made were as follows:-

- i. On average, public sector earnings are assumed to rise at about the same rate as in the private sector, except for an addition due to teachers; it is assumed that the Baker proposals are implemented in the second quarter of 1987.
- ii. Central government manpower is assumed broadly unchanged. Within the total, Civil Service manpower falls slightly and health service manpower rises after 1987-88. Local authorities' manpower has recently begun to grow again and is assumed to increase at around  $\frac{1}{4}$  per cent per annum, in terms of full-time equivalents, over the forecast period.
- iii. Cash limits on central government expenditure are assumed not to be breached for 1986-87; allowance is made for discretionary additions from the Reserve reflected in Supplementaries. Expenditure of £650m on Rover is assumed for 1986-87. For future years the forecast of cash-limited expenditure derives from the earnings and employment assumptions and realistic projections of real growth in procurement.
- iv. The forecast assumes that the level of (Aggregate Exchequer) grant for local authorities in 1987-88

is based on the plans except for some additional grant in respect of the teachers' pay deals. Because the forecast implies that spending plans will be exceeded, and grant penalties applied, the level of grant as a percentage of total relevant expenditure in 1987-88 is forecast to be 46.6 per cent compared with 48.4 per cent in the plans. Outturn grant percentage is assumed to continue at that level in future years.

- v. The latest view of the prospects for asset sales is assumed for 1986-87 and £5 billion per annum thereafter. British Airways is assumed to be sold in 1987 Q1.

3. The table below compares the main economic assumptions used in the 1987 PEWP with the forecast.

	1986-87	1987-88	1988-89
<u>GDP deflator %</u>			
PEWP	3	3½	3½
Forecast	3.0	4.4	5.1
<u>Unemployment (GB, narrow)</u>			
<u>million</u>			
PEWP	3.1	3.05	3.05
Forecast	3.03	2.78	2.71
<u>Short Term Interest Rates %</u>			
PEWP	10¼	10¼	8½
Forecast	10.6	11.0	11.0
		Sept 87 on Sept 86	Sept 88 on Sept 87
<u>RPI%</u>			
PEWP		3½	3½
Forecast		5.0	4.9

## SECRET

## ANNEX B : AVERAGE ERRORS FROM PAST FORECASTS

	JANUARY FORECAST		Average errors
	1987	1988	from past forecasts*
<b>A. Output and expenditure at constant 1980 prices</b>			
	<u>per cent changes</u>		
Domestic demand	3½	2½	1
of which:			
Consumers' expenditure	3½	3	1½
General government consumption	2	1½	1
Fixed investment	3½	3½	2½
Change in stockbuilding (as per cent of level of GDP)	½	0	¾
Exports of goods and services	4½	2	2½
Imports of goods and services	7½	2	3
Gross domestic product: total	3	2½	¾
: manufacturing	3	3½	2½
	<u>£ billion</u>		
<b>B. Balance of payments - current account</b>	-3	-3½	3
<b>C. Inflation</b>			
	<u>per cent changes Q4 to Q4</u>		
Retail prices index	4½	5	2½
	<u>1987-88    1988-89</u>		
	<u>per cent changes on previous year</u>		
Deflator for GDP at market prices	4½	5	2
	<u>per cent changes on previous financial year</u>		
<b>D. Money GDP at market prices</b>	7½	8	1¾

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\*1975(1)-1984(4)

SECRET

## PSBR IN 1986-87

The Year So Far

1. Table 1 summarises the position for the nine months to December, comparing it with the profile constructed at the time of the Budget. Chart 1 makes the same comparison. At end-December the cumulative PSBR was nearly £3 billion below the Budget profile, with central government own account borrowing accounting for just over half of the undershoot, and local authorities and public corporations each accounting for about one fifth of it.

TABLE 1: PSBR APRIL-DECEMBER\* - £ billion  
(receipts -, outlays +)

	Budget Profile	Outturn	Difference between outturn and Budget Profile	
			£b	%**
<u>CG Receipts</u>				
Non-oil taxes	-67.3	-69.5	-2.2	-3
Oil taxes and royalties	-3.5	-2.5	+1.0	+28
NIC's	-15.9	-16.3	-0.5	-3
Privatisation proceeds	-2.9	-3.3	-0.4	-14
Other receipts	-	-0.5	-0.5	-
<u>CG Outlays</u>				
Supply and other expenditure	90.7	91.6	+0.9	+1
Debt interest (net expenditure)	6.0	6.1	+0.1	+1
CGBR(O)	7.1	5.5	-1.6	-
LABR	0.5	-0.3	-0.8	-
PCBR	-0.1	-0.7	-0.6	-
PSBR (excluding privatisation proceeds)	7.4 (10.3)	4.5 (7.7)	-2.9 (-2.6)	-

\* figures may not add due to rounding

\*\* a dash indicates that percentage changes are not meaningful



**Table 2: Borrowing Requirement profiles: January forecast**  
(1986 Budget profiles in italics for comparison)

£ billion

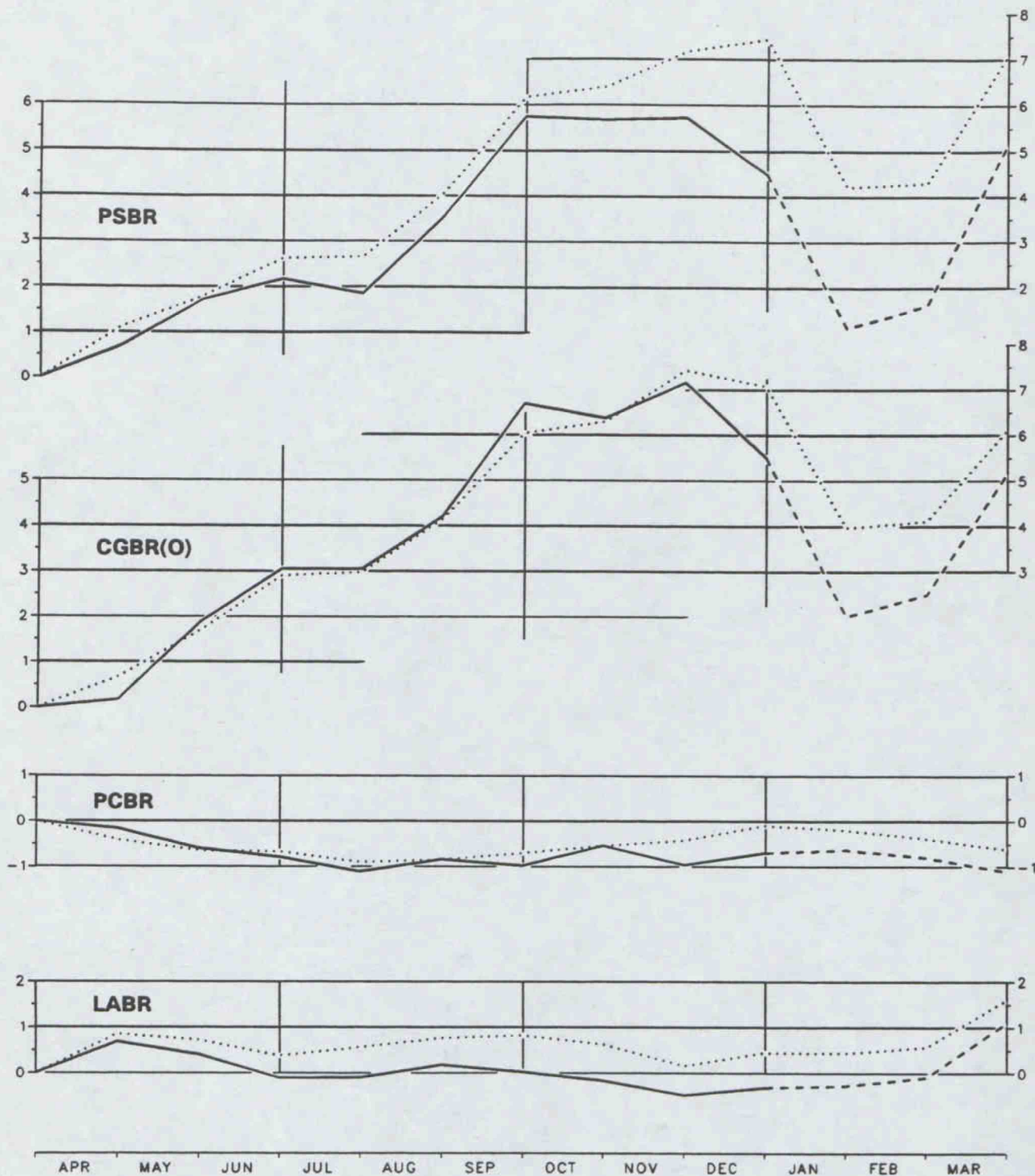
	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1986-87								
Apr	<b>0.7</b>	<i>1.1</i>	<b>0.2</b>	<i>0.7</i>	<b>0.7</b>	<i>0.9</i>	<b>-0.2</b>	<i>-0.4</i>
May	<b>1.0</b>	<i>0.7</i>	<b>1.7</b>	<i>1.0</i>	<b>-0.3</b>	<i>-0.1</i>	<b>-0.4</b>	<i>-0.2</i>
Jun	<b>0.5</b>	<i>0.8</i>	<b>1.2</b>	<i>1.2</i>	<b>-0.5</b>	<i>-0.3</i>	<b>-0.2</b>	<i>-</i>
Jul	<b>-0.3</b>	<i>-</i>	<b>-</b>	<i>0.1</i>	<b>-</b>	<i>0.2</i>	<b>-0.3</b>	<i>-0.2</i>
Aug	<b>1.7</b>	<i>1.4</i>	<b>1.2</b>	<i>1.2</i>	<b>0.3</b>	<i>0.2</i>	<b>0.3</b>	<i>0.1</i>
Sep	<b>2.2</b>	<i>2.1</i>	<b>2.5</b>	<i>1.9</i>	<b>-0.1</b>	<i>0.1</i>	<b>-0.1</b>	<i>0.2</i>
Oct	<b>-0.1</b>	<i>0.2</i>	<b>-0.3</b>	<i>0.3</i>	<b>-0.2</b>	<i>-0.2</i>	<b>0.4</b>	<i>0.2</i>
Nov	<b>0.1</b>	<i>0.8</i>	<b>0.8</b>	<i>1.1</i>	<b>-0.3</b>	<i>-0.5</i>	<b>-0.4</b>	<i>0.1</i>
Dec	<b>-1.2</b>	<i>0.3</i>	<b>-1.6</b>	<i>-0.4</i>	<b>0.2</b>	<i>0.3</i>	<b>0.3</b>	<i>0.3</i>
Jan	<b>-3.4</b>	<i>-3.2</i>	<b>-3.5</b>	<i>-3.1</i>	<b>-</b>	<i>-</i>	<b>0.1</b>	<i>-0.1</i>
Feb	<b>0.5</b>	<i>0.1</i>	<b>0.5</b>	<i>0.1</i>	<b>0.2</b>	<i>0.1</i>	<b>-0.2</b>	<i>-0.2</i>
Mar	<b>3.6</b>	<i>2.8</i>	<b>2.7</b>	<i>2.0</i>	<b>1.2</b>	<i>1.0</i>	<b>-0.3</b>	<i>-0.2</i>
Cumulative								
Apr	<b>0.7</b>	<i>1.1</i>	<b>0.2</b>	<i>0.7</i>	<b>0.7</b>	<i>0.9</i>	<b>-0.2</b>	<i>-0.4</i>
May	<b>1.7</b>	<i>1.8</i>	<b>1.9</b>	<i>1.7</i>	<b>0.4</b>	<i>0.7</i>	<b>-0.6</b>	<i>-0.6</i>
Jun	<b>2.2</b>	<i>2.6</i>	<b>3.1</b>	<i>2.9</i>	<b>-0.1</b>	<i>0.4</i>	<b>-0.8</b>	<i>-0.7</i>
Jul	<b>1.9</b>	<i>2.7</i>	<b>3.1</b>	<i>3.0</i>	<b>-0.1</b>	<i>0.6</i>	<b>-1.1</b>	<i>-0.9</i>
Aug	<b>3.6</b>	<i>4.1</i>	<b>4.2</b>	<i>4.2</i>	<b>0.2</b>	<i>0.8</i>	<b>-0.8</b>	<i>-0.8</i>
Sep	<b>5.8</b>	<i>6.2</i>	<b>6.7</b>	<i>6.0</i>	<b>-</b>	<i>0.8</i>	<b>-1.0</b>	<i>-0.7</i>
Oct	<b>5.7</b>	<i>6.4</i>	<b>6.4</b>	<i>6.3</i>	<b>-0.2</b>	<i>0.6</i>	<b>-0.5</b>	<i>-0.5</i>
Nov	<b>5.7</b>	<i>7.2</i>	<b>7.2</b>	<i>7.4</i>	<b>-0.5</b>	<i>0.2</i>	<b>-1.0</b>	<i>-0.4</i>
Dec	<b>4.5</b>	<i>7.4</i>	<b>5.5</b>	<i>7.1</i>	<b>-0.3</b>	<i>0.5</i>	<b>-0.7</b>	<i>-0.1</i>
Jan	<b>1.1</b>	<i>4.2</i>	<b>2.0</b>	<i>4.0</i>	<b>-0.3</b>	<i>0.4</i>	<b>-0.6</b>	<i>-0.2</i>
Feb	<b>1.6</b>	<i>4.3</i>	<b>2.5</b>	<i>4.1</i>	<b>-0.1</b>	<i>0.6</i>	<b>-0.8</b>	<i>-0.4</i>
Mar	<b>5.2</b>	<i>7.1</i>	<b>5.2</b>	<i>6.1</i>	<b>1.1</b>	<i>1.6</i>	<b>-1.1</b>	<i>-0.6</i>

Figures for April to December are outturns; January to March figures are consistent with January forecast

**Chart 1 : Comparisons with Budget profiles for 1986-87**

£ billion cumulative

- = Estimated outturn in 1986-87
- - - = January forecasts
- ..... = Budget profile



Forecast for 1986-87

2. Table 3 and chart 1 summarise the latest forecast for 1986-87 as a whole.

TABLE 3: PSBR IN 1986-87\* - £ billion

(receipts -, outlays +)

	Budget Forecast	January Forecast	Difference between Budget and January Forecasts	
			£b	%**
<u>CG Receipts</u>				
Non-oil taxes	-95.5	-98.3	-2.8	-3
Oil taxes and royalties	-4.8	-3.7	+1.1	+23
NIC's	-21.7	-22.2	-0.4	-2
Privatisation proceeds	-4.8	-4.6	+0.2	+4
Other receipts	-	-	-	-
<u>CG Outlays</u>				
Supply and other expenditure	124.1	124.8	+0.8	+1
Debt interest (net expenditure)	8.8	9.1	+0.3	+3
CGBR(O)	6.1	5.2	-1.0	-
LABR	1.6	1.1	-0.5	-
PCBR	-0.6	-1.1	-0.5	-
PSBR (excluding privatisation proceeds)	7.1 (11.9)	5.2 (9.7)	-1.9 (-2.1)	-

\* figures may not add due to rounding

\*\* a dash indicates that percentage changes are not meaningful

3. The CGBR(O) in the year as a whole is forecast to undershoot the Budget forecast by £1 billion, compared with an undershoot of £1.6 billion at end-December. The main reasons for the reduction in the cumulative undershoot expected in the next three months are:

- (i) privatisation proceeds so far are £0.4 billion above the level assumed in the Budget profile but the annual target is assumed to be undershot

by £0.2 billion. This assumes £½ billion for BA, £¼ billion for BGC debt and £0.1 billion for Royal Ordnance, giving an annual total of £4574 million. Latest information, available after the forecast numbers were finalised, is that the total might turn out nearer £4.5 billion than £4.6 billion.

- (ii) the unusually high level of central government bank deposits (included in other receipts in the tables) at end-December is assumed to unwind.
- (iii) the repayment of APRT in March (£0.3 billion) announced in the Autumn Statement.
- (iv) expenditure of £650 million on Rover not anticipated in the Budget profile.

These factors are partially offset by others, particularly non-oil tax receipts, working in the opposite direction.

4. The projected monthly profile of the CGBR(0) is as follows:-

- in **January** a surplus of £3½ billion is forecast. This reflects the seasonal peaking of Inland Revenue receipts. January is the main month for the receipts of schedule D income tax (totalling £1 billion) and mainstream Corporation Tax (totalling nearly £4 billion); receipts of Advance Corporation Tax (totalling over £1 billion) are also high. National insurance contributions are high and national insurance benefit funding is low. These factors are partly offset by high supply expenditure (due to payments of student grants and high rate support grants), low interest receipts and some unwinding of the large rise in bank deposits in December.
- in **February** borrowing of £½ billion is forecast. Privatisation proceeds (sale of BA) are assumed to raise £½ billion. VAT receipts will be high (as they are in May, August and November).

- in **March** the CGBR(0) is forecast to be £2½ billion. Expenditure on Rover of £650 million is included. Adjusting for this, the end-year surge in supply expenditure is slightly higher than last year, though lower than in 1984-85. Privatisation proceeds (repayment of BGC debt and sale of Royal Ordnance) are assumed to raise £¾ billion. Interest receipts are high as are debt interest payments.

5. There are a number of uncertainties about the forecast. It is still a little early to know with any accuracy how much corporation tax will be received in January, although there is some indication of receipts in the first three weeks. The payment in December of £¾ billion of tax due in January complicates the assessment. If December and January are taken together in an attempt to avoid this complication, the position is that receipts (including ACT) to the third week of January amount to approximately £5½ billion. Inland Revenue advise that this is consistent with the £6 billion allowed for in the forecast. A further uncertainty arises from the end-year surge in expenditure which is difficult to judge. This year there is the added uncertainty of Rover which could either slip into 1987-88, or, more likely, be different from the amount assumed.

6. The paucity of monthly recorded information on the components of LA and PC borrowing creates considerable difficulties for the forecast of the rest of the financial year. Quarterly data on income and expenditure is available only for the first half of the financial year. In these circumstances the forecast is based partly on the latest monthly figures for borrowing and partly on the quarterly forecast of income and expenditure. The quarterly income/expenditure analysis points to lower **LA borrowing** in 1986-87 than in 1985-86, both because of a higher current surplus - the growth of rate and grant income is estimated to have picked up more sharply than that of current expenditure - and because of lower capital spending.

7. For the forecast of the LABR we have given considerable weight to the well-established pattern of high borrowing in the last quarter of the financial year. There does not seem

to be a discernible tendency in recent years for low borrowing in the first nine months to be offset in the last three or vice versa. Table 4 below sets out the previous experience and the forecast. The forecast of the LABR in the last quarter is a little higher than the average of recent years, but there is some suggestion of a rising trend.

**TABLE 4: LABR - £ billions**

	<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
First 9 months	-1.1	0.1	1.2	0.4	-0.3
Last 3 months	1.1	1.1	1.2	1.3	1.4
Annual	0.1	1.2	2.4	1.7	1.1

8. Virtually all of the local authority borrowing in the last quarter of 1986-87 will be undertaken in March, so it will be well after the Budget before there is any clue to the outturn. However the results of a DOE survey of LA borrowing intentions should be available in the first half of February.

9. Past borrowing patterns of **public corporations** as a whole are not a good guide to the current year's prospective outturn because privatisation has changed the composition of the sector and the PCBR in 1984-85 and 1985-86 was heavily distorted by the coal strike. Adjusting for the effect of privatising BT and the coal strike, as in table 5, shows that the PCBR on an underlying basis has fallen in recent years and that a further fall is forecast for 1986-87.

**TABLE 5: RECORDED AND UNDERLYING PCBR, RECENT FINANCIAL YEARS (£bn)\***

	<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u> (Forecast)
Recorded PCBR	1.5	0.4	1.2	0.0	-1.1
Privatisation adjustment	+0.4	+0.3	+0.4	-	-
Coal strike adjustment	-	-	-1.6	-0.6	-
Underlying PCBR	1.9	0.6	-0.1	-0.6	-1.1

\* components may not add to total due to rounding effects

10. The estimated outturn for the first 9 months of 1986-87 supports the view that the PCBR will be substantially negative over the whole year. This is partly a reflection of an expanding economy with underlying output of nationalised industries growing at a reasonably quick pace.

11. The forecast incorporates a repayment of borrowing of £0.4 billion in the final quarter mainly due to a high forecast repayment by the electricity industry. This is mainly a seasonal effect, from high winter fuel bills benefitting the industry's cash flow, and is likely to be bigger than usual this year on account of the unusually low temperatures experienced for much of January.

**PSBR: Comparison with 1985-86**

12. Table 6 and chart 2 compare this year's outturn and forecast with the experience of the last two years. The cumulative outturn to December 1986 is about £3 billion below the figure for the same period in 1985-86. However the forecast implies that borrowing in 1986-87 as a whole will undershoot 1985-86 by only £0.6 billion. The main differences between the last quarter of 1985-86 and the forecast for the last quarter of 1986-87 are:-

- (i) receipts of  $\frac{1}{4}$  billion of PRT (including APRT) in 1986-87 compared with receipts of  $\frac{1}{2}$  billion in 1985-86.
- (ii) composite rate tax receipts from building societies of  $\frac{1}{4}$  billion in 1986-87 compared with  $\frac{1}{2}$  billions in 1985-86. Payments are now made in instalments rather than once a year.
- (iii) expenditure of  $\frac{3}{4}$  billion on Rover this year. There were no lumpy items of expenditure of this magnitude last year.
- (iv) nearly half of the increase in gilt interest payments between the two years falls in the last

quarter of the financial year. This increases borrowing in the last quarter by about £½ billion compared with last year.

These factors are partly offset by privatisation proceeds being £¼ billion higher in the last quarter of 1986-87 than in 1985-86.



Table 6 PUBLIC SECTOR BORROWING REQUIREMENT - Comparison with the last two years

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1984-85	1985-86	1986-87	1984-85	1985-86	1986-87	1984-85	1985-86	1986-87	1984-85	1985-86	1986-87
	Apr	1.9	1.1	0.2	0.9	0.8	0.7	-0.4	-0.2	-0.2	2.4	1.8
May	3.2	2.4	1.9	0.8	0.8	0.4	-0.4	-0.5	-0.6	3.6	2.7	1.7
Jun	4.5	2.7	3.1	0.6	0.5	-0.1	-0.5	-0.6	-0.8	4.6	2.6	2.2
Jul	5.0	3.6	3.1	0.8	0.8	-0.1	-0.7	-1.3	-1.1	5.1	3.1	1.9
Aug	6.2	4.6	4.2	1.4	0.9	0.2	-0.7	-1.2	-0.8	6.8	4.3	3.6
Sep	6.5	5.1	6.7	1.2	1.1	0.0	-0.2	-0.6	-1.0	7.5	5.6	5.8
Oct	6.7	5.0	6.4	1.0	0.7	-0.2	0.3	-0.4	-0.5	8.0	5.3	5.7
Nov	8.5	6.2	7.2	0.8	0.1	-0.5	0.4	-0.3	-1.0	9.7	6.0	5.7
Dec	7.8	7.3	5.5	1.2	0.4	-0.3	1.3	-0.1	-0.7	10.3	7.6	4.5
Jan	5.7	2.8	2.0	0.9	0.5	-0.3	1.2	-0.1	-0.6	7.8	3.1	1.1
Feb	5.1	2.7	2.5	1.3	0.4	-0.1	1.3	-0.4	-0.8	7.8	2.7	1.6
Mar	6.6	4.1	5.2	2.4	1.7	1.1	1.2	0.0	-1.1	10.2	5.8	5.2

Figures January-March 1986-87 are latest forecasts

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**Chart 2: Comparisons with last year's outturns**

£ billion cumulative

- = Estimated outturn in 1986-87
- - - = January forecasts
- ..... = 1985-86 outturn

