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PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief which we have been preparing for the Prime Minister's information before her weekly Question Time (and which is still drafted to meet that purpose) but which we now propose to circulate more widely among Treasury and non-Treasury Ministers.

This week's brief does not take account of the transfer of some of the former CSD's functions to the Treasury. Whether and how to do this is under consideration.

Changes from the previous Brief, of 9 November, are sidelined.

M M Deyes

M M DEYES

R.A

R I G ALLEN

16 November 1981

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires strict adherence to firm monetary and fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What has Government achieved during term of office so far?

Removed constraints on market forces: reduced Government regulation and bureaucracy; fostered a new mood of realism; improved incentives to enterprise and efficiency. Specific measures to help small businesses to start up and/or expand. Manufacturing output up 1½ per cent in third quarter. Inflation below 12 per cent - nearly halved since Spring 1980 peak. Unemployment in latest three months rising less than half as quickly as in last quarter of 1980.

4. When will upturn in economy come?

Latest figures (published 12 October) suggest some rise in industrial production since spring 1981. Manufacturing productivity (output per man) up 5 per cent since end-1980. Unit wage costs in manufacturing have shown little rise in first half 1981. [NB but rising more strongly again now]. Competitiveness improved. Prospects depend above all on further success in reducing inflation and improving industrial competitiveness and productivity.

5. Major economic statement to be made in November?

In the normal course of events, some announcements will have to be made in the autumn.

6. When will Industry Act forecast be published?

A forecast will be published this autumn in the usual way.

7. British business in crisis? Manufacturing bearing the brunt?

Government has done a good deal to create right conditions for business to thrive but recession has obscured them. Best help Government can give is further progress in bringing down inflation. Many signs companies now tackling problems ignored for far too long. Unreasonable to expect problems of years to be solved overnight. Growing evidence of improvements in productivity and competitiveness.

8. Productivity gains normal in recession?

[P Kellner in N. Statesman 13 November.]

Productivity has held up well in relation to fall in manufacturing in last 2½ years. Both output per hour for whole economy and output per man hour in manufacturing are higher than in first half 1979.

9. Productivity gains mean job losses?

No. Productivity a way of improving competitiveness and securing more growth in the economy.

10. Current unemployment levels intolerable? Going to get worse?

No immediate prospects for unemployment turnaround but the rate of increase has slowed markedly since turn of year. Less short time working, overtime picking up. The prospects depend crucially on securing further reductions in pay settlements and increasing productivity so obtaining improved competitiveness. This is the way to get real sustainable jobs.

11. Cost of unemployment?

[MSC estimate reported in Financial Times 9 November used to under pin pressure for reflation]

(See C9.)

12. 10 per cent November inflation target now impossible? Inflation bound to get worse? Sacrifices have been for nothing?

Developments since the Budget (particularly fall in exchange rates) have certainly worsened short-term inflation outlook. But Government expect downward trend will continue, though precise timing is difficult to predict.

13. Government's pay policy means falling living standards?

If recent improvement in competitiveness is to continue, we must achieve further reductions in pay settlements in the coming round. It is now clear that the increase in retail prices in the year to November 1981 will be higher than the 10 per cent forecast in the FSBR. (See also Section J.) Acknowledge this could mean lower real incomes in short term. But best way to safeguard jobs and build longer term prosperity. And must be set against 17½ per cent rise in RPDI in 3 years to 1980.

14. Government has failed to check public spending?

Public spending this year is expected to be somewhat higher than we had originally planned. An important reason for this is that we took the effect of the recession into account when we prepared our most recent plans. We remain committed to containing public spending. The annual review is currently in progress (see further Section E). [IF PRESSED on when results will be made public; Main decisions for 1982-83 will be announced within the next few weeks. Full details will be published in the next Public Expenditure White Paper on Budget day next year.]

15. Government has failed to allow accommodation to the recession?

Accusations we are inflexible in our tactics are unfounded. Have been flexible within the limits of prudence over the levels of public spending and public deficit.

16. Government being flexible to point of laxity?

We must be flexible about particular policies while holding in place our policy framework. We cannot and will not allow the foundations to be destroyed.

17. Why are high interest rates needed?

Current level of interest rates has reflected developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1 per cent from the peak in September.

18. Rapid growth in £M3 shows slackening in monetary squeeze?

Not followed £M3 target slavishly to exclusion of all else. Allowed overshoot last year because judged could do so without endangering objectives for reducing inflation.

19. Is the MTFS still Government policy?

The MTFS sets out our broad strategy on fiscal and monetary policy. Objective is to provide assurance Government will continue to provide financial discipline. Judged by results, rather than precise numbers, we have done just this. (See also section H).

20. MTFS shot to pieces?

Completely untrue to say we have failed to achieve MTFS. Main objective is reduction in inflation, and progress here has been good. £M3 growth has been higher than we would have liked, though narrow measures of money have grown more slowly. But growth in nominal GDP (as discussed in November Economic Progress Report) seems to have been growing by about 10 per cent in first half 1981. The PSBR for this year is likely to be much as expected at the time of the 1981 Budget.

21. Government should change course?

[Most recent commentary from Sir Ian Gilmour, Max Wilkinson and S Brittan in FT.]

(a) Moderate reflation the answer?

Government has shown willingness to adapt to recession and is allowing higher PSBR than envisaged last year. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing a resurgence of inflation, and as a consequence interest rates rising further and faster. Economically and politically this is nonsense: no Western government believes it, and our own painful experience (1971-73, 1974-76) refutes it. George Cardona has pointed out in FT 16 November the prize to be won in lower inflation by maintaining thrust of Government strategy.

(b) Reintroduce exchange controls and join EMS?

Exchange controls are a very modest and limited weapon, and the EMS is not a panacea. No substitute for responsible monetary and fiscal policies. Creating a European island of currency stability, as rt hon Gentleman (Mr Heath) suggests, will not of itself eliminate instability vis a vis the dollar, yen or OPEC world.

(c) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

(d) Cut NIS?

See D11.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Is recession over?

Ministers have been saying for many months that fall in output was ending. This now appears to be the case. Firmest evidence to date that fall in output is now over comes from latest figures for industrial and manufacturing output. In third quarter manufacturing output increased by 1½ per cent. Some improvement in financial position of company sector (see N3).

IF PRESSED: Evidence not conclusive

Recognise all usual uncertainties. Equally I see no virtue in ignoring what has occurred. There has been a substantial improvement since the end of last year. Manufacturing output has picked up, labour market indicators have improved (see C1). This year has seen higher engineering and construction orders and increased private sector housing starts, compared with the second half of last year. (See B4 for independent forecasts).

[IF ASKED about decline in CSO's longer leading indicator: Too early to judge significance; recall that temporary weakening occurred in last cycle.]

[NOTE: 3rd quarter GDP figures to be published 18 November; new cyclical indicators 19 November]

2. Government assessment of prospects

Budget forecast assessment suggested beginnings of recovery in H2 1981. New Industry Act forecast will be released by Treasury around the end of the month.

3. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	$^1/_3$	1	
NIESR (Sept)	1	1¼	
CBI (Aug)	0	½	
Phillips & Drew (Nov)	0	½	
OECD (July)	$-^1/_3$	0	

Recent major independent forecasts assess that low point in activity was reached in first half of year, with prospect of some recovery in the coming year.

4. Where will recovery come from?

Mainly from the reversal of the same factors that contributed to the downswing. There are signs that the rate of destocking is slowing, the savings ratio can be expected to decline further as inflation abates, and some recovery is expected in world trade. Additionally productivity and competitiveness are now improving [see second half of B6].

5. Recovery slow?

Never claimed it would be rapid [FSBR shows 1 per cent growth in GDP in year to H1 1982]. Economy has weakened cumulatively during the post war period. Have created the opportunities and foundations for improved economic performance.

6. Higher interest rates will abort recovery? Business confidence weakened?

Understand concern over higher interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Manufacturing productivity in second quarter some 5 per cent up on final quarter of last year. Together with last pay round's lower level of settlements, this has meant only a small rise in manufacturers' wage costs this year. This can be expected to contribute towards improved profitability and competitiveness.

7. Recession worse than in the 1930s?

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[October total count was 2,989,000 (12.4 per cent). Seasonally adjusted excluding school leavers figure was 2,729,000 (11.3 per cent)]

Unemployment rising much less rapidly. Increase in recent months less than half those at end of last year [50,000 per month in 3 months to October 1981 compared with 115,000 per month in Q4 1980]. Also should note dramatic reduction in short time working in manufacturing - down ¾ from that at turn of year. Overtime showing signs of picking up. Result is that total hours worked have stabilised over recent months within manufacturing sector.

2. Unemployment accelerating?

[Monthly increases, seasonally adjusted, excluding school leavers, in 4 months July-October have been successively 30,000; 44,000; 46,000; 56,000]

True there has been some apparent upward drift in rate of increase over recent months (As figures involve some degree of estimation [due to emergency procedures because of civil service dispute] their reliability is somewhat uncertain.) Nevertheless it remains the case that labour market indicators are much more favourable than at turn of year (see C1 above). IF PRESSED FURTHER: Unemployment forecasts and assessments always uncertain. What is essential is that all participants in the economy contribute to improved economic opportunities. Crucial to this is further moderation in pay settlements.

3. Employment continues to fall?

[Employment fell a further ¼ million in Q2 1981 much the same as in Q1. Total decline since mid-1979 1.7 million or 7½ per cent.]

Decline in manufacturing employment showing signs of slackening in August (17,000 compared with about 50,000 per month earlier in year). [See also C1 above].

4. Government forecasts for unemployment

[Public Expenditure White Paper published Budget Day used working assumption of an average level of 2.5 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.7 million in 1982-83. Government Actuary's Report published 3 July revised 1981-82 assumption to 2.6 million. NB new GAD report will shortly be published]

Like previous administrations Government does not publish forecasts of unemployment, though Government Actuary Reports etc contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 5 below for independent forecasts.]

5. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982. In wake of SEMs, some forecasters (NIESR, CBI and P&D) revised down earlier forecasts by about 0.2 million.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in range especially for beyond next year. Some forecasters reduced their assessments following announcement of SEMs.

6. True level of unemployment is far higher than official figures?

[TUC now state it is above 4 million.]

Unemployment statistics are published on the same basis as under previous administration. MSC has wisely commented (in paper to NEDC) "the current definition provides a good and well understood series for discerning trends and once that firm ground is left, there is endless scope for statistical and semantic debate." We are concerned about unemployment however defined. But our policies are laying foundation for creation of secure employment.

7. Unemployment higher than in other countries?

[OECD standardised data show UK Q1 1981 at 10¼ per cent compared with OECD average of 6½ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

8. Would work-sharing help reduce unemployment?

I doubt whether this is the answer. We prefer to leave the determination of hours and working schedules to the decision of employers and workers who know the local conditions. But unless people prepared to accept reduction in income commensurate with reduction in hours, effect on productivity and competitiveness likely to make worksharing counter productive.

9. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector, unemployment (similar figure estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. This figure has received much attention eg FT front page 9 November.

Latest HMT estimate (Written PQ) is £415 million for extra 100,000 registered private sector unemployment in 1981-82. This compares with £340 million for 1980-81 published in Economic Progress Report February 1981. Latter figure now revised to £360 million.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed.

As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereb y affecting estimates by changing earnings, prices, taxes and benefits.]

10. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

11. Should spend more, especially for young people?

In July announced further provision for special measures of around (gross) £700 million in 1982-83. A large part of this was for young people, including the new Young Workers Scheme. For the future, I expect my rhF the Employment Secretary will soon announce substantial further measures in the form of a comprehensive training scheme for the young unemployed.

12. Need to improve training at all levels?

Agree. Aim must be both to help individual and strengthen economy by having a better trained workforce. Government has fully endorsed objectives of MSC's New Training Initiative. We shall be making a statement later in this session about the role which the Government and others can play.

13. Unemployment as bad as in the 1930s?

Comparisons extremely difficult to make. Maximum recorded unemployment in 1930s was just under 3 million; but the labour force has grown by about $^1/_3$ since, so unemployment rates in the 1930s almost certainly higher than now. One also needs to bear in mind changed social conditions and protection given by the welfare state.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 35 per cent of GDP (at market prices), 36½ per cent in 1979-80, 38 per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. British taxes rose more sharply than in any other leading industrial nation in 1980?

[OECD report quoted in The Times 18 October]

Burden of taxation has inevitably increased during a time when national production has not been growing. This re-emphasises the need to control public expenditure and reduce inflation. The OECD report shows that the whole Government 'take' (by way of taxation and national insurance contribution) as percentage of GDP in Britain is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG position is that national insurance contributions are not a tax - compare F3].

3. Government policy regressive?

Largest percentage reductions in take-home pay, as a result of March Budget, were for those with very high incomes.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Wrong not to index personal allowances in March Budget?

To index personal allowances would have cost £1900 million in 1981-82 (or £2,500 million in a full year). Circumstances did not permit such a large injection of resources into the personal sector this year. We thought it right to concentrate what help we could afford on the company sector.

6. Taxation of unemployment benefit?

Unemployment benefits paid from 5 July 1982 onwards will be liable to tax. The delay in bringing the scheme into operation is due to the complex administrative arrangements. (IF PRESSED: civil service dispute was one of factors which led to starting date being delayed from April 1982. Cost of deferment will be of the order of £100 million.)

7. Indirect tax increases inflationary?

True that the indirect tax increases have added to the RPI. But by reducing public borrowing, they will help to bring inflation down in the longer run and ensure that it stays down.

8. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

9. Reduce petrol/derv duties?

Pump price also dependent on pricing policies of oil companies and world market conditions. Real value of derv duty now about 60 per cent of 1970 level, and of petrol duty no higher than in 1970.

10. Not enough tax relief for industry in the Budget?

Direct help given to industry in the Budget, despite the tight constraint, has been considerale and under-estimated. The Budget gave a major concession on stock relief (costing some £450 million in a full year) and help worth £120 million to help keep down industrial gas and electricity prices.

11. Reduce National Insurance Surcharge?

[Chancellor remineded CBI on 1 November of key importance of wages in costs, and told them no prospect of NIS being abolished. Institute of Directors have called for precedence to be given to cuts in income tax over cuts in NIS.]

Fully aware of all representations and of strength of feeling in some quarters in favour of reductions. But important to remember that wages are major element in industrial labour costs. Remains one of possible candidates for reduction if resources available. Scope for any tax measures dependent on what decisions reached on public spending. NIS (like income tax) a major revenue raiser, producing £3.8 billion in current year, and very costly to reduce.

12. Progress with examining corporation tax structure?

[Promise to re-examine corporation tax structure in 1980 Budget Speech]

It is hoped to produce the Green Paper on corporation tax this winter.

13. What about 'inflation tax' suggested by Roy Jenkins at SDP Conference and Professor Layard in recent Guardian article?

Such a tax would essentially be a form of income policy with all the well known defects of such. (See J11). In addition collecting such a tax would mean considerable extra work for the Inland Revenue in monitoring pay settlements and identifying firms which would be liable. It would go against our policy of simplifying the tax system.

14. North Sea fiscal regime?

See R3.

E PUBLIC EXPENDITURE AND FINANCE

1. Government has failed to cut public expenditure?

The recession has created pressure to increase spending. We took this into account in our plans. Remains our policy to contain public spending.

2. Will Government make further cuts in public spending?

We are now looking at our plans and at proposals for spending over the next three years. Our decisions on public expenditure will be announced in due course.

3. Cuts of £5 billion proposed?

[Treasury Ministers proposed at Cabinet on 20 October totals for 1982-83 which were in fact somewhat higher than had been planned in the last White Paper].

Talk of cuts in the total of public expenditure is misconceived. We have already agreed some increases in earlier plans - notably the £¾ billion employment package announced last July - and we are discussing other proposals for increases. Government is having to decide how far to accept these and how far to offset by cuts in other expenditure.

4. How much higher than planned?/Large increases in plans likely?

[The media quote a figure of £5 billion as a possible increase over planned spending and Chief Secretary said on BBC radio 21 October; "What is proposed is a figure for public spending which is higher than that which is, at present, allowed for; and the question is, how much higher one should go"].

Cannot say at this stage. That is what we are discussing. Every survey of public expenditure involves looking at proposals for new or additional spending as well as at proposals for reductions and ways of offsetting increases. This is what we are doing now and involves taking into account changing circumstances and examining the implications of planned spending for fiscal and monetary policy.

5. Increase capital spending?

If not offset by cuts in current spending, this would mean more inflation and would be paid for by the private sector by more taxation, higher interest rates or both. The need is to contain overall spending.

6. Cut current not capital/Cut current to allow more capital spending?

The Government's objective is, wherever practicable, to give priority to worthwhile capital projects providing this involves no overall increase in public expenditure. Must not oversimplify distinction between current and capital spending. Capital expenditure frequently necessitates additional current expenditure which it is difficult to accommodate at a time when our main objective is to reduce the overall level of public expenditure.

7. 4 per cent a pay norm?

[The overall cash provision for the pay element of public expenditure was arrived at using a factor of 4 per cent for the movement from 1981-82 levels to 1982-83 levels]

Not a pay norm. Represents the overall increase in the pay bill for which provision is being made. A limit on the overall size of the pay bill, not on settlements - some may be less and some may be more.

8. 9 per cent a forecast of inflation?

[A factor of 9 per cent for the movement in public sector prices between 1981-82 and 1982-83 has been used in arriving at the cash provision for non-pay items for 1982-83 and later years]

Not a forecast of inflation. This is the allowance we have made for the overall increase in public sector prices over the coming year.

9. Public spending overwhelmingly on administration?

[90 per cent figure quoted by some critics]

Not all current expenditure is on administration. One-third is current payments such as money paid out to old age pensioners, and the unemployed, child benefit and so on. One-fifth is for purchase of goods and services, for example for defence. One-tenth is grants such as overseas aid and subsidies. Only a third of current expenditure is on wages and salaries, and much of that is for nurses, teachers, policemen, soldiers and so on. We made it clear in the White Paper, Efficiency in the Civil Service, (published last July) that the Government is seeking ways of improving efficiency and cost consciousness in the Civil Service.

10. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is the smallest for over 14 years and we are well on target to achieve our aim of having by end of this Parliament the smallest Civil Service since the war. Local authority manpower has been reduced by nearly 70,000 (over 3 per cent).

11. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

12. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

The ratios in 1980-81 (44½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46½ per cent in both years). The large rise from 41½ per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen.

LOCAL GOVERNMENT

13. England: Measures to combat overspending

Although most local authorities in England are planning expenditure in line with the Government's targets, a few have increased their budgets. As a result, the overall total for current expenditure remains about 5½ per cent (Nov '80 prices) above the Government's plans. In view of this my rhF the Environment Secretary will be obliged to seek Parliamentary approval to reduce the total of rate support grant. Individual authorities which meet their target or spend less than their Grant Related Expenditure assessment will not lose grant.

14. Scotland: Measures to combat overspending

Scottish local authorities' original targets were 8.8 per cent (Nov '80 prices) above the Government's plans. In the light of this my rhF the Secretary of State for Scotland has withheld £31 million from three authorities which he considered were planning excessive and unreasonable expenditure. These authorities have now reduced their budgets. In view of the general high level of spending my rhF also intends to withhold a further £35 million from all authorities.

15. Rates: Powers to control

Local Government Finance Bill had First Reading 6 November. It includes provisions to make authorities planning excessive expenditure more accountable by obliging them to seek approval from their electors in a referendum.
[Note: It is assumed the PM's Office will be in touch with Department of the Environment for latest developments.]

16. Rates: Alternatives

A Green Paper on alternatives to domestic rates will be published very shortly.

F SOCIAL SECURITY

1. Press Reports that the deficit on the National Insurance Fund will force an increase in contributions?

[An announcement on contribution rates would normally be made in late November, but might this year be delayed to early December.]

Certainly there is a predicted deficit on the National Insurance Fund this year and it is likely, unless we take action, that it will be repeated next year. But no decision has yet been taken on the level of contributions for 1982-83. My rhF the Social Services Secretary is likely to make an announcement on this in a few weeks time.

2. Will the Government ensure that the burden on employees/employers will not rise?

Whether or not we increase contribution rates, there is likely to be a cash increase in the amounts paid both by employers and employees because of increases in earnings, and, potentially, from changes to the earnings limits between which contributions are levied. Earnings limits or thresholds normally rise annually in line with prices.

[IF PRESSED: On employers: I am well aware of the need to limit the burden placed on employers. Members will recall that the increase in rates last year was confined to employees. But I cannot anticipate the decision we will be taking.

On employees: In deciding the level of contributions we shall ensure that we place no unjustifiable burden on employees.]

3. National Insurance Contributions are a tax?

National Insurance contributions are not a tax; they are paid into the National Insurance Fund specifically to meet the cost of national insurance benefits.

4. Statutory sick pay plans place new burden on employers?

[Social Security Bill, published on 6 November provides for reform of housing benefits and a statutory sick pay scheme (SSP). Most employers will gain from SSP, but some will lose]

Overall we expect employers to gain from the method of compensation we have adopted. The CBI have recognised this and welcome the proposals.

[IF PRESSED: Employers will be compensated for the statutory sickness payments themselves, but not for the national insurance contributions and surcharge levied on them. Those employers who have no existing occupational schemes will, therefore, lose. This is unfortunate, but it applies to a relatively small proportion of sickness payments; and we believe that the advantages of the scheme outweigh this disadvantage.]

5. Government's forecast of 10 per cent inflation by November 1981 unlikely to be achieved; will it make good shortfall in November social security up-rating?

[Most social security benefits are due to be increased by 9 per cent from 23 November (Child Benefit and Mobility Allowance by slightly more). 9 per cent increase based on Budget-time forecast of movement in prices November 1980 to November 1981 of 10 per cent, less 1 per cent to allow for over-payment in November 1980 increases.]

If we under-shoot this year, we can expect pensioners to catch up at the next uprating.

6. Government planning to cut real value of social security benefits?

[Press report in The Times 15.10.81 of intended cuts in unemployment benefit and deferment of child benefit uprating]

Social Security Benefits, including Child Benefit, will be uprated in November by the amounts announced at Budget time and approved by Parliament. The level of upratings in November 1982 will be announced in due course. All public expenditure programmes are currently under examination; the social security programme cannot be excused from this process.

7. Does Government intend to ensure that social security beneficiaries will have received all benefit to which legally entitled during civil service dispute?

[Frank Field and others have suggested some claimants being denied benefit to which were entitled (primarily Earnings Related Supplement) but which may not have received during dispute].

This is essentially a matter for my rhF Social Services Secretary. But if individuals think they have received less than their entitlement they should get in touch with the local office dealing with their claim.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Budget forecast PSBR in 1981-82 was £10.6 billion; PSBR in April - September, published 5 November, was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR

[CGBR April-October was £9.2 billion]

The shortfall of net revenue outstanding at the end of October from the start of the dispute was around £5½-6 billion. £¾-1 billion of this shortfall affected March; the remainder this financial year. Interest costs on the additional borrowing caused by the dispute are over £¼ billion.

3. Will the Government be able to collect all delayed revenue this financial year?

It is not yet clear how soon all the delayed revenue will be collected. Since the dispute ended at the end of July, response has been quite good.

4. Public expenditure likely to overrun this year?

It is too early to say what the outturn for the current year will be.

[IF PRESSED: The local authorities are, admittedly, spending above the Government's plans. We are taking measures to deal with that but these measures cannot be effective this year. Expenditure which is under the Government's direct control is running broadly according to plan in total.]

5. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

6. PSBR next year will be £3½ billion higher than planned because of expenditure increases?

No. The size and shape of total plans for public spending next year are still being considered, alongside the likely revenue. When these two factors are set alongside each other a decision will be made about the size of the PSBR. No decisions have yet been made.

H MONETARY AND FINANCIAL POLICY

[NOTE: Chancellor appearing before TCSC Monday 16 November to answer questions on monetary policy.]

1. Why has general level of interest rates risen?

[Clearing bank base rates rose by 4 percentage points to 16 per cent in September but have since fallen back 1 per cent.]

Immediate reason was pressure on sterling and rapid pace of bank lending. But important to note that rates overseas had been rising since the spring and while measures we took in the Budget enabled us for some months to keep our rates from being pulled up, we could not fly in face of developments abroad.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates?

High UK interest rates were partly due to international pressures including exchange rate developments; partly a response to the acceleration in bank lending. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that higher interest rates will increase difficulties of industry. But no purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. When can we expect interest rates to fall? Effect of declining US rates?

Clearing banks have already slightly reduced base rates. But cannot take for granted that lower interest rates abroad can be fully reflected in lower rates in UK. Nor can we promise a large or sustained reduction in interest rates while rapid growth of bank lending remains a threat to inflation.

5. What will Government do about the Michael Grylls study group report?

This was produced independently for the Conservative Backbench Industry Committee but the Government are looking at its analysis and proposals with interest.

6. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

7. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvements to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

8. Where is underlying money supply growth in relation to target?

[£M3 increased by $1\frac{1}{2}$-$1\frac{3}{4}$ per cent in banking October, bringing recorded increase in first eight months of target period to $12\frac{1}{2}$ per cent. But position remains seriously distorted by effect of civil service dispute and aftermath.]

Cumulative distortion to £M3 is very large. Extremely difficult to say where we are in relation to target. Remain determined not to fuel inflation by excessive growth of money supply.

9. Will there be an overshoot?

Too early to say.

10. When will the strike distortions be eliminated?

Distortion will continue for some months yet. It will increase again in banking October as Customs & Excise made VAT repayments more rapidly than they recovered outstanding VAT. Customs & Excise have been giving priority to refunding businesses affected by the strike. But from now on recoveries by Government are expected to exceed repayments.

11. Status of MTFS now?

[Press comment about a prospective Government announcement on revised MTFS is pure speculation. Have also been Press suggestions that £M3 target base will be rolled over this November; Prime Minister knows that we have made no commitment to such a rollover]

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators, prospects for inflation, exchange rate, etc.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 11.7 per cent in October.

2. Inflation back on a rising trend?

[Year-on year rate of inflation rose to 11.7 per cent in October compared with 11.4 per cent in September and lowest recent level of 10.9 per cent in July. Effect of mortgage interest increases estimated at around ½ per cent on RPI in November, some 2/3 per cent in December.]

Progress on inflation has been affected by the fall in the exchange rate, and the rise in the mortgage interest rate will affect the RPI. We expect further progress in reducing inflation, but the timing is of necessity uncertain.

3. Budget time forecast achievable? (10 per cent by Q4 1981; 8 per cent Q2 1982)

[NOTE: Industry Act forecast due this autumn will include revised assessments for RPI and new forecast to Q4 1982.]

Now clear that increase ub retail prices between November 1980 and November 1981 will be more than 10 per cent envisaged at Budget time, though precise figures impossible to predict at this stage. Over-run mainly due to fall in exchange rate, partly to higher mortgage interest rates. Government confident that downward trend in inflation will be resumed.

4. 9 per cent increase in prices in 1982-83?

The 9 per cent price factor for preparing public expenditure plans for next year represents what is considered a realistic provision for the prices to be paid by departments. It is not a precise forecast.

5. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI.

6. TPI

The fact that the TPI has been increasing faster than the RPI (3½ per cent faster over the year to October) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

7. A 4 per cent pay policy?

[Government accused of discriminating against civil service - BBC radio interview with FDA Secretary 12 November]

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at the stage of fixing the programme from which the public service wage bill has to be met.

8. Public sector ignoring 4 per cent policy?

[NUM have rejected revised offer worth 7.3 per cent on earnings; firemen now settled at 10.1 per cent; water manuals offered 6.7 per cent]

Pay negotiations in local government and the nationalised industries are a matter for the parties concerned, as are the financial consequences of any settlements reached. There is no pay norm. What we need are settlements which are consistent with maintaining economic recovery and improving employment prospects. [NB Not enough settlements so far in private sector to comment on trend there.]

9. Government aiming to cut living standards?

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

10. Comparison of TPI and earnings index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

11. Tax-based incomes policy

[As in Mr Jenkin's proposals at SDP conference]

Like any other attempt to rely on incomes policy, a tax-based incomes policy would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

12. Index-linked pensions and the Scott Report

[Sunday Express 15 November gave examples of large impending increases for some recipients when pensions uprated next week; Sir William Clark asking for debate soon on Report (Hansard 12 November col 669).]

We hope to reach initial conclusions on the issues in next few months. General objective is to ensure that public service pensions should be fair, fairly paid for, and seen to be so. This principle will determine future decisions.

K BALANCE OF PAYMENTS

1. September trade figures disappointing?

[September trade figures were published 20 October. Because of Civil Service dispute, last published trade figures were for February].

The figures are encouraging if extremely hard to interpret - coming after long gap. But exports (volume) have increased significantly, when most commentators expected them to have declined. And imports (volume) rising to around the level of 18 months ago is not inconsistent with our assessment that there are signs of recovery in industrial output.

2. Main features of figures for balance of payments in Q2 1981?

The net identified outflow on capital account was about £1.9 billion in Q2 compared with over £3 billion in Q1. The surplus on invisibles was £0.9 billion in Q2.

3. Overseas flows a drain on the economy?

Outflows on the capital account are the necessary counterparts to our recent healthy current account surpluses. Overseas investment will provide a valuable source of income from abroad in future. There is no evidence that outflows deprive UK firms of investment.

4. Will Government reintroduce exchange controls?

[Analysis of effect of abolition is contained in October issue of Economic Progress Report]

No. Exchange controls were an unnecessary administrative burden on the economy. We have no intention of reintroducing them.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since July sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 13 November were $1.9040; DM4.21 and an effective rate of 90.09. Reserves at end October stood at $23.2 billion, compared with $23.7 billion at end September]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is now around the same level as when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Sterling should join the EMS?

[See M13]

4. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of perhaps 10 per cent so far this year. This is partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

5. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. By end of 1981, total official external debt will be reduced to around $14 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. Cost to UK of membership too high?

Costs and benefits of UK membership of the Community must be viewed as a whole. We realise the need for reform of the Community financing as well as my hon Friend/the hon Member. We have already achieved a major reduction in our net contribution through the agreement reached on 30 May 1980. We shall continue to press for reform of the common agricultural policy (CAP) and restructuring of the Community Budget.

2. Net contribution too high?

A lot lower than it would have been without the agreement of 30 May last year. Important to build on that as soon as possible.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We shall need to examine the new Commission estimates with care. If it is true that our adjusted net contribution in respect of 1980 and 1981 will turn out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

Have seen press reports that other member states take the view that our refunds should be reduced in those circumstances. The UK, however, is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Does recent vote of European Parliament's Budgets Committee to freeze part of 1982 budget provision for UK refunds mean UK will not receive its full entitlement to budget refunds?

No. The draft amendment supported by the Budgets Committee was not supported by the Parliament when it voted in plenary session on 5 November.

6. What are the payment arrangements for supplementary measures?

Community payments are made to Government Departments with policy responsibility for the investment programmes concerned.

7. Do supplementary measures grants lead to additionality?

There is additionality in important sense that refunds are making possible a higher level of public expenditure in the regions and elsewhere than would otherwise have been possible. Both the participating authorities and other spending authorities are gaining the advantage of a higher level of expenditure than country could otherwise have afforded. Scheme does not, however, open way to increases in expenditure by participating authorities beyond levels already planned. In that sense there is no additionality.

8. Do participating regions and programmes benefit?

Yes - in important sense explained in answer to previous question.

9. How can refunds both enable a higher level of public expenditure and reduce PSBR? (Compare answer on 3.6.80 Hansard col 1241)

There is no inconsistency here. The refunds are reducing PSBR. Without them, further cuts in domestic expenditure programmes would have been needed to reduce PSBR.

10. Policy for CAP reform

Greater attention must be paid to the needs of the market, and action taken to curb surplus production and contain the growth of guarantee expenditure. Will continue to press for price restraint and other measures appropriate to surplus sectors.

11. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

12. What if we hit the 1 per cent VAT ceiling before 1982?

Our position is that there will not be an increase in the 1 per cent VAT ceiling, and discussions on the restructuring of the budget and other matters are within that firm context.

EUROPEAN MONETARY SYSTEM

[Press reports "teach-in" at No 10 deferred]

13. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N . INDUSTRY

1. Recent increases in interest rates - damaging for industry and investment?

(Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.)

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Encouraging evidence that fall in output has now come to an end. Too early to talk about recovery: but index of manufacturing output rose by nearly 2 per cent in the 3 months July-August over the previous three months with chemicals, metal manufacturing and engineering performing particularly well. [NB Industrial production figures for September due out Tuesday 10 November].

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £3¾ billion in Q2 1981 for third successive quarter. Borrowing requirement of ICCs has improved over last year, and financial deficit turned into surplus. Company liquidity has also improved markedly this year; company sector's liquidity position better in second quarter this year than at any time since third quarter of 1979].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

4. NEDC meeting 11 November - TUC attack on government's plan to privatize BNOC

My rt hon Friend the Secretary of State for Energy gave the NEDC a full justification of the Government's proposals for BNOC along the lines outlined in his speech to the House on Tuesday 10 November.

5. NEDC task force shows that industrial energy prices in the UK are still out of line with the continent

The report of the NEDO task force shows that the gap between energy prices in the UK and on the continent has been narrowed, and, in the case of gas and foundry coke, been eliminated altogether. This partly reflects the measures announced by the Government and implemented by the fuel industry the last report of the NEDO task force.

SMALL FIRMS

6. Government help for small firms

Government has taken major steps to encourage enterprise in the important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

7. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued close on 1200 guarantees - well over half to new businesses. Total lending under scheme is already over £41 million. Substantial demand for loans has led the Government to double this year's lending limit under the scheme (to £100 million). (Overall commitment over three years stays unchanged for the present.)

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early next year.

8. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

1. Government policy on nationalised industries

To reduce State ownership and improve efficiency of publicly owned enterprises. Market forces are to be brought to bear, and private capital is being introduced - where appropriate. Competition Act has been used to refer selected nationalised industry operations to the Monopolies and Mergers Commission.

INVESTMENT

2. Government just not allowing for enough nationalised industry investment?

No. The latest Public Expenditure White Paper shows nationalised industry planned investment rising from £4.5 billion in 1980-81 to £5.2 billion in each of the next three years (at 1980 Survey Prices) or a 15 per cent increase in real terms. The quantity of investment frustrated by tight EFL's is less than implied. TSSC report published last August estimated in range of £250-500 million this year.

3. Increased NI investment would boost private industry and add to productive potential?

Depends on whether or not extra investment is accommodated within existing public sector totals. If it were allowed to add to borrowing requirement, it would tend to raise interest rates and discourage other expenditure, including some private sector investment. Except in short term, net effect on private sector might not be beneficial and effect on future growth of productive potential is uncertain. Report from all-party TCSC accepted that there could be such financial "crowding-out".

4. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

5. New forms of finance for NI investment?

(The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting, which noted the report; survey of the main options and of the circumstances in which direct market finance might be justified. It was agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

6. Status of proposed British Telecom bond? If agreed, will this bond be outside PSBR and relevant EFL?

No. This is borrowing by a public sector body, thus public sector borrowing. And the Government, with its overall responsibility for BT's finance must continue to place limits on its external finance. But the EFL might be somewhat larger on account of the bond than it otherwise would be.

7. What problems have delayed the expected announcement? Does proposal meet criteria set out in the NEDC Working Party Report?

[Two criteria:- extra cost must be justified by pressure for greater efficiency; terms of investment won't involve unfair competition with private sector].

An intensive effort has been made to conclude this question, in the context of the public expenditure exercise and the decision on BT's EFL for 1982-83. Certain problems remain to be resolved before a decision can be taken.

[IF PRESSED: They are:-

(a) Cost to BT of the borrowing - will be greater than gilts, but the Government and BT must be sure that this will be justified by the contribution the bond makes to pressures for improved efficiency and profit.

(b) BT's pricing policy - some arrangement is needed to assure investors that BT's profits would not be constrained by the Government's holding prices down. But Government must protect consumers as well as investors. This is an industry where prices ought to fall in real terms, because of technological advance, ie to rise by less than the RPI. We have not so far been able to agree on a formula to deal with this]

8. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

9. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £125 million per annum; and each 1 per cent off total costs saves £300 million.

NATIONALISED INDUSTRY PAY

10. Pay assumption for next year's external financing limits?

The Government has made clear the need for significantly lower pay settlements across the economy. It is in the industries' own interests to secure their future by leaving enough room for investment. The Government has not set any norms for the industries, but it is bound to take a close interest in settlements in reaching its decisions on investment and finance.

NATIONALISED INDUSTRY PRICES

11. Nationalised industries' prices have risen more rapidly than RPI?

True over last year or so, while artificial and distortionary prise restraints introduced by the Labour Government were working through the system. Unwelcome but inevitable: the only alternative is an increased burden on the taxpayer and a distortion of market forces.

12. What is happening now?

Nationalised industry price increases are falling [14 per cent above RPI in year to January, 3 per cent above in year to October]. Fully expect them to come closer to RPI in next few months.

13. And the future?

Better price performance depends on improvements in efficiency and control of current costs, particularly pay. We are determined to see those improvements brought about. Privatisation and increasing competition have an especially important role here.

PRIVATISATION

[Announcements in week ending 24 October referred to Cable and Wireless, National Freight Corporation Ltd, BNOC's oil-producing business and BGC's monopoly of purchase of oil and its sale to industry; BR Hovercraft.]

14. The Government simply selling valuable national assets to achieve PSBR target?

Of course, the cash is welcome, but the benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

15. TUC attack on proposals for BNOC

(see N4)

16. Why is disposal of BGC's gas showrooms to be delayed?

HMG has made it clear that safety standards must be fully maintained - this will require complex legislation, for which there is unlikely to be time during this Session.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. We shall be announcing further measures in due course.

18. Will these include British Leyland?

The 1982-83 Corporate Plan for BL being submitted shortly will doubtless refer to the prospects for disposals.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. North Sea oil price rises following OPEC price reunification?

Price of North Sea oil is a matter of commercial negotiation between BNOC and the oil companies.

3. Will HMG change North Sea fiscal regime in line with oil industry's proposals?

[Memoranda lodged with Treasury and D/Energy 22 October].

I commend UKOOA (UK Offshore Operations Association) and BRINDEX for the hard work which they have put in. Obviously full study of their proposals is required. We shall look at their suggestions with an open mind, in close liaison with UKOOA and BRINDEX.

4. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

5. Gas gathering pipeline - why did HMG not proceed?

The project has always been envisaged as a private sector utility. The vast bulk of economically recoverable gas will be brought ashore and this can and should be left to private enterprise as in the past. Note that oil companies are already planning a series of North Sea gas pipelines.

6. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

7. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special fund would make no difference. More money would not magically become available. So the money for this special fund would have to come from somewhere else - lower public expenditure, higher taxes or higher public borrowing.

8. North Sea oil bond?

We expect to issue the North Sea oil bond, an entirely new kind of National Savings certificate, in January.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Combined GNP in major economies flat in Q2. Little information on Q3. But small fall in US GNP for second consecutive quarter. And signs that industrial production stagnating in major seven countries. Average unemployment rate steady but likely to worsen. IMF and OECD forecasts suggest some recovery towards end of this year. Unemployment may level off in H2 1982].

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected next year. And unemployment should level off during the year.

2. OECD gloomier about world economic prospects?

[Draft report referred to in Sunday Times 15 November]

Latest OECD forecast is still being prepared. Most major forecasts, including the IMF's, expect modest growth next year. OECD forecasts unlikely to be markedly different.

3. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries around 10 per cent in September. Underlying rates increasing in US and France. OECD and IMF expect some decline next year.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 10 per cent in September 1981. Further decline expected next year.

4. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

5. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

6. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

7. Other governments not following such stern policies as UK?

[US, Canada and Germany have announced lower monetary targets for this year compared with last. Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

8. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

9. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

10. Recent comments by US Budget Director have undermined confidence?

[Press reports of Dr Stockman's description of Budget spending cuts as "hastily prepared and enacted" and tax cuts "Trojan horse" favouring the rich, while casting doubt on "Supply side" policies].

I note that Dr Stockman has apologised for his "careless ramblings to a reporter".

11. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to 17 per cent from peak of 21½ per cent; also German rates declining.

12. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 16 November 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, ST JAMES) assess recession's trough was reached in H1 1981, with some recovery in year to H2 1982 (in range ½-2¼ per cent). Item are more pessimistic , seeing output fall a further 2 per cent in 1982, recovery thereafter. Unemployment forecast to increase but only Item (3¼ million 2H 1982) see it reaching 3 million (narrow definition) by end 1982. Most forecasters see year-on-year inflation in range 10½-11 per cent for Q4 1981, falling to 9-10½ per cent in Q4 1982. Item and St James are more pessimistic; forecasting range of 13-15 per cent. Item see a sharp drop, well into single figures in 1983.

GDP output estimate fell ½ per cent in Q2 1981 following a similar fall in Q1 and an average quarterly fall of 1½ per cent throughout 1980. In the 3 months to July manufacturing output increased by 2 per cent over the preceding 3 months.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales fell nearly 1 per cent between Q2 and Q3 1981. Volume of visible exports in September were 6 per cent above the average in January and February. Volume of visible imports were 24 per cent higher on the same comparison. Manufacturing investment (excluding assets leased from the service sector) fell 2½ per cent in Q2 1981. Distributive and service industry investment (including shipping and leasing) rose 4½ per cent in Q2 1981. DI investment intentions survey (conducted in April/May) suggests a fall in manufacturing investment after allowing for leasing of 11 to 14 per cent in 1981 with some recovery in 1982; distributive and service industries investment (including shipping) expected to rise by less than 5 per cent in both 1981 and 1982. Manufacturers', wholesalers' and retail stocks dropped by £0.5 bn (at 1975 prices) in Q2 1981 compared with destocking of £0.4 bn in Q1 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl. school-leavers) was 2,728,900 (11.3 per cent) at October count, up 56,000 on September. Vacancies rose slightly to 98,600 in October.

Wholesale input prices (fuel and materials) were unchanged in October but stand 18 per cent higher than a year earlier; wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase was 11.7 per cent in October. Year-on-year increase in average earnings was 12.8 per cent in August. RPDI fell by 2½ per cent in Q2 1981 after a 1½ per cent fall in the previous quarter and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio fell 2 per cent to 12½ per cent in Q2 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to October - £9.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 increased by $1\frac{1}{2}$ - $1\frac{3}{4}$ per cent in banking October but distorted by the consequences of the civil service dispute.

Visible trade showed a surplus of £13 million in September compared with an average monthly surplus of £368 million over the period July 1980 to February 1981. Invisibles surplus in first three quarters of 1981 estimated at £2.1 billion. Reserves at end-October $23.3 bn. At the close of 13 November the Sterling Exchange rate was $1.9125 and the effective rate was 90.7.

cc Mr Wolfson ✓
Mr Howe ✓

Grant Rd

Mr Cardona's article reported in the FT 16/11/81

WILL THE GOVERNMENT REFLATE?

This note is an attempt to analyse the pressures on the Government for and against reflating before the next election. Reflation is here used to mean taking measures that would allow monetary growth in excess of ranges in the Medium Term Financial Strategy (MTFS). It is defined in this way because one could argue that the Government's stance is already reflationary: there is a sizeable public sector deficit, and monetary growth is at present higher than both the recent and prospective rate of inflation. However, these are problems about defining monetary growth (something familiar to observers of the British economy) and there has never been a period during the life of the MTFS when the readings given by the monetary figures could have been said to be really clear.

The most fundamental reason for supposing that there will not be any reflation is both moral and economic. The Government, in the sense of the majority of the Cabinet, quite simply believe in the Government's economic strategy and they want to do what they think is right. They believe that past experience of managing the British economy shows that reflation would have a small short-term impact on employment but would, in the slightly longer run, lead to higher inflation, a lower level of sterling (if not a collapse) and a worsening of the structural problems that have afflicted the British economy for so many years.

Of course there is always room for argument about exactly how many members of the Cabinet—apart from the economic ministers—are fully committed to the strategy. It is only natural that there should always be people with anxieties, and there are also people so busy managing their own departments that they never really have time to immerse themselves in economic issues. But one must take people at face value. Every member of the Cabinet must be considered a supporter of the strategy unless he resigns. No Cabinet minister has shown any sign of resignation, and there is no reason to suppose that any will. Whenever there have been Cabinet discussions of macro-economic policy, the Government's strategy has been endorsed.

This does not mean that there are no internal arguments. There are an infinite number of ways to juggle the equation of public expenditure proposals, tax proposals and interest rates to try to arrive at the monetary growth provided for in the MTFS. But the fact that there are always internal arguments for the press to seize on does not mean that the Cabinet is not determined to press on with the overall strategy.

The most important argument urged by those in the Party who want reflation, and by those outside who think the Government will reflate, is the apparently obvious one that the Government should reflate in order to win the election. This argument is accepted quite uncritically by a large number of people, yet it is demonstrably weak, and the members of the Cabinet perceive it to be weak.

First of all there are the lessons of recent history. The Heath Government reflated as the election approached, though probably not so much for electoral reasons as out of very genuine concern about the level of unemployment. Yet that Government lost the next election. (Admittedly the February 1974 election was held in rather special circumstances. But there are always going to be unpredictable special factors in any election; certainly the lesson seems to be that reflation does not help). The Callaghan Government reflated before the 1979 election, and lost by a massive margin.

A more subtle electoral calculation that could be made by the present Government is this. Reflation now could well be followed by either a sterling or funding crisis of some severity. The interest rates that would have to be used to defend sterling or to fund in such a crisis would make interest rates of 16-17 per cent (at the time of writing) look positively pleasant. Such extra high interest rates would result in more bankruptcies and a further check to growth and employment; and the crises here presupposed would make the Government look incompetent and less likely to be re-elected.

Even if, making a more optimistic assumption, reflation were not followed by a funding or sterling crisis, the impact on unemployment by the time of the election would be minimal. One well known simulation was that published by David Blake in the Times during the summer. He argued that an extra £4 billion in public borrowing might reduce unemployment by about 100,000. (There have been other simulations published, but David Blake's is probably the clearest and best known).

A reduction in unemployment of some 100,000 could have no significant impact on the election. It would probably mean unemployment of, say, 2.8 million instead of 2.9 million; or 2.7 million instead of 2.8 million. To suppose that a grateful public would re-elect a Conservative Government in such circumstances is naive nonsense. The public will, quite rightly, regard any level of unemployment above 2½ million as very high indeed. They will not stop to wonder, before casting their vote, whether unemployment might have been slightly higher had there been a smaller PSBR two years before the election.

There is, therefore, no question but that the Conservative Government will have to face the next election with a high level of unemployment and playing around with the figures and assumptions would not alter this conclusion. Even a reduction in unemployment of 250,000 would not bring the total below 2½ million (always assuming there was not a crisis after any attempt to bring unemployment down by such a margin).

There is no choice for the Government but to fight the next election with high unemployment. But there is a choice about inflation. If the Government sticks ot its strategy it can realistically hope for a very healthy—and falling—inflation rate of, say, 5-6 per cent, by the election. If things went very well indeed—such as some unpredictable political event in the USA pushing really large capital flows into sterling—then the Government could actually achieve an outturn of 3-4 per cent inflation. If things went less well, the outturn could be 7-8 per cent. That is still quite creditable. But if the Government were to reflate, then it would be more likely to fight the election with inflation at, say, 12-16 per cent and rising. That would impress nobody. It would also be very unstable; it could easily accelerate upwards. It would be very likely to do so if the reflation were part of a deal with the trade unions under the terms of which they restrained pay demands—for by 1984, after a few years of restraint, their members would be determined to press for higher pay awards.

The choice before the Government is therefore to fight an election with higher unemployment and low inflation, or with higher unemployment and high inflation. The former is obviously better. So the Government has every electoral interest in sticking to its strategy.

Nevertheless, the question may still be asked: what if enough members of the Conservative Party do not see the political arguments this way, and they try to force a change of course on the Government?

Again one must look at the recent past. At the time of writing, the "Wets" have not organised themselves into a coherent group either for lobbying or voting. They are certainly not a Party within the Party; they are not even a tendency. (It is no criticism of them to say they are not an organised group: it has not been their intention to organise). They have not voted against the Government as a group, partly because there has not been an issue on which they felt strongly enough to vote against their own Government and partly because there are not many of them. Any political journalist would be hard put to name twenty "Wets".

There is certainly a small group of highly intelligent and articulate "Wet" members of Parliament who have a good deal of influence on the Press.

But they are greatly outnumbered by the many back-benchers who are convinced the Government's broad strategy is correct. It is highly significant that the only important Parliamentary revolt which the Treasury has faced during this Government was over the price of petrol and not over the Government's strategy. The rebels in that case were mainly the solid supporters in the rural shires, voting in a constituency interest.

Although the number of committed "Wets" is small, one cannot overlook the possibility that just enough members might be found to vote against a Budget that contained dramatic increases in taxation. But this is not how the Conservative Party—or indeed any other political party—works. The Budget is indeed secret until the moment it is announced, and it is true that even the Cabinet do not see the Budget until it is almost ready to be announced; but the Budget is not prepared in a political vacuum. Members of Parliament who are worried will have delicately given notice of their positions through the Whip's office, which is probably one of the most effective intelligence networks anywhere in the world. When the Budget is finally put together it naturally takes account, as far as possible, of the known predilections of members on the Government's side (and of course of political pressures generally). This system is not infallible. It broke down when the decision was taken to raise the retail price of petrol by 20 pence in the 1981 Budget, largely because public protest was expected to concentrate on the failure to improve personal allowances. But by and large the system works to safeguard Government from introducing legislation which cannot be passed. Forewarned is forearmed: the Government should know enough soon enough about the disposition of Parliamentary forces to find ways of meeting the MTFS targets.

There are other political pressures on the Government which have not been discussed so far. One is the emergence of the Social Democratic Party. It is sometimes said that the Conservative Party will have to trim to the left if it is not to lose votes, or MPs, to the SDP. But the reality is by no means so obvious or clear-cut. What is interesting about the evidence available on the motives of voters who threaten to switch from the Government to SDP is that they criticise the Government from the Right as often as from the Left. Thus they criticise the Government's generosity towards nationalised industries and they urge a tougher policy on trade unions; but on the doorsteps they do not usually call for a bigger PSBR or loose monetary policy—though admittedly some do call for lower interest rates.

Another political factor that has been dragged into the debate about whether the Government should reflate is last summer's rioting. The assumption is that high unemployment causes social stress, such as the inner city riots. It is a doubtful assumption: unemployment is probably only one factor out of many (and moreover high inflation also produces social strains). But even if it were true that inner city riots were caused only by unemployment, to reflate the entire economy would be a senseless way to deal with the problem of four or five parts of the country. The sensible policy is that which the Government has already followed: to direct attention and funds at the areas affected.

CONCLUSION

The main burden of the argument of this note is that the Government will stick to its overall economic strategy, not out of stubbonness or a temperamental inability to change, but because to persevere with the strategy is in the interests both of the country and of the Conservative Party. To reflate now would lose the Government the next election.

There could, of course be unintended reflation if borrowing by local authorities and nationalised industries overshoots such provision as may have been made for it. And there may be some cosmetic changes designed to lessen the burden of criticism—for example, some further help to industry on energy prices is possible, but it would be cosmetic for PSBR purposes because it would be paid for out of the contingency reserve. There will, however, be no *policy* of reflation.

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Government 'resigned to high total of jobless'

By David Marsh

THE GOVERMNENT is resigned to fighting the next election with unemployment high, probably well above 2.5m. It will not reflate the economy before then because of the fear of further worsening its re-election chances by adding to inflation, according to Mr George Cardona, who has just left his job as one of the Treasury's political advisers.

In an article to be published in the Economic and Monetary Review of London stockbrokers Laing and Cruickshank next month, Mr Cardona—a keen devotee of present government policies of "sticking firm"—says reflation would have only a minimal impact on unemployment by the next election.

It would however push up both inflation and interest rates. If the Government stuck to its present strategy, it could realistically hope for a "healthy" inflation rate of around 6 to 7 per cent by the next election.

Mr Cardona, who was attached to the office of Mr Nigel Lawson, former Financial Secretary, departed from the Treasury in September when Mr Lawson became Energy Secretary.

He says in the article that unintended inflation could take place if borrowing by local authorities and nationalised industries overshoots.

Reflation through extra public borrowing might mean, by the next election, unemployment of 2.8m instead of 2.9m or 2.7m instead of 2.8m. "To suppose a grateful public would re-elect a Conservative Government in such circumstances is naive nonsense."

Moves to expand the economy could trigger a sterling or funding crisis. Higher interest rates would arise that would make recent levels of 16 to 17 per cent look "positively pleasant."