Prime Minister

This is not a very helpful note but I have put it in in case you wanted some commentary on the NIER

We are getting more useable material for Tuesday. The FT leader (copy attached) is quite good.

MCS 27/11

You have a copy

1. MR ~~SHIELDS~~ 26/11/81
2. CHANCELLOR OF THE EXCHEQUER

c Chief Secretary	Mr P Dixon
Financial Secretary	Mr Evans
Economic Secretary	Mr Kemp
Minister of State (L)	Mr Monck
Sir Douglas Wass	Mr R I G Allen
Mr T Burns	Mrs Gilmore
Sir K Couzens	Mrs Lomax
Mr Ryrie	Mr Riley
Mr Quinlan	Mr Sedgwick
Mr Byatt	Mr J Page
Mr Middleton	Mr Mowl
Mr Britton	Mr Hibberd
Mr Cassell	Mr Redley
	Mr Ridley
	Mr Harris
	Mr Cropper

NATIONAL INSTITUTE REVIEW

The November issue is to be published tomorrow. Its situation report on the UK economy concludes, as it has before, that a reflationary fiscal stance is now required. The claim that supply constraints now exist is examined and dismissed, as is the danger of a strong resurgence of wage inflation. A list of alternative reflationary policies costing £5 billion is offered, together with an assessment of their cumulative effect over a five year period.

Forecasting the UK Economy

2. The period of the Institute forecast has been extended from two to five years to add emphasis to their presentation of the case for reflation. It is claimed that though the trough of the recession may have passed the future path of the economy will remain flat in the absence of intervention. The GDP forecast is markedly less optimistic in the short term than the Treasury's, although the employment consequences of the two forecasts are broadly the same. By the end of 1986, NIESR suggest that unemployment will have risen to 3.4 million.

3. The table below compares the main features of the NIESR projections until 1982 with the latest internal Treasury update designed for the forthcoming Industry Act Forecast.

		NIESR	Treasury IAF Latest Update
Retail Prices:			
% change year on year	1981	12.0	11.9
	1982	10.7	11.4
GDP			
% change year on year	1981	- 3.1	- 2.1
(1975 prices)	1982	0.6	0.9
Unemployment			
4th quarter, UK wholly	1981	2.8	2.8
unemployed, excluding school leavers	1982	3.0	3.1
PSBR			
£ billion (calendar years)	1981	11	12
	1982	11	6
Balance of payments			
(Current Account £ billion)	1981	4.2	6.5
	1982	4.5	1.9

3. On inflation, the expected rate of price increase is forecast to slow to 10.7% in 1982 and to 8.3% in the following year. However the downward inflexibility of real wages which is assumed in the NIESR model suggests that no further downward movement in inflation can be expected. The PSBR does not fall appreciably in the Institute's review until after 1983 when the rise in oil revenues is sufficient to offset the costs of further rises in unemployment. Some reduction in interest rates is foreseen next year.

4. The other major difference with the Treasury forecast lies in the balance of payments. Despite a lower projection of the current account surplus in 1981, NIESR forecast substantial surpluses continuing into 1982 and 1983. This reflects a more buoyant assessment of export prospects and slower growth in import volumes, although NIESR emphasise the uncertainty of their projections. The exchange rate is expected to stay roughly at current levels.

Policy Appraisal

5. The Institute's gloomy projections reflect their scepticism about automatic stabilisation processes which would bring the economy back without intervention towards what they would consider a full employment level within an acceptably short period. They reject what they term the monetarist case against a policy of active demand management on the grounds that it presupposes a stable economic system which is close to equilibrium. By contrast, they see a situation in which demand has for some years fallen so far short of a high-employment level of output that the overriding priority of public policy should be towards closing the gap. The Review also includes an assessment of causes of the short-fall in output between 1979 and 1981. Drawing on papers presented by the NIESR and the London Business School to the Bank of England's Panel of Academic Consultants, the Review points to the restrictive stance of fiscal and monetary policy and the rise in the real exchange rate (itself partly reflecting these policies) as the main explanations for the severity (although not the origin) of the recession.

6. The reflationary packages suggested by the Institute are not shown to be particularly effective in bringing down the projected unemployment levels. A cut in income tax costing £5 billion gross per year is assessed to reduce unemployment by 150,000 to 200,000 after five years, with a fairly small (perhaps even a negative) effect on the price level. Increases in government spending on goods and services of a similar gross amount would produce an effect on unemployment of over 300,000 although having a worse effect on inflation (raising the price level by perhaps 7 per cent in five years). Wage subsidies or cuts in indirect taxes produce a similar benefit in terms of unemployment to that of an income tax cut, but with beneficial effects on the rate of inflation.

M G REDLEY
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FINANCIAL TIMES
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A 1930s cure for the 1980s

THE VIEW that the recession and the grim rise in unemployment are largely or entirely the result of mistaken Government policy is naturally very popular among politicians. The appearance of a carefully reasoned case for this view, based on a medium-term projection of UK prospects is therefore likely to be more influential than a routine short-term forecast from the National Institute for Economic and Social Research, and deserves close attention.

Obsession

The review argues that the Anglo-American obsession with so-called supply-side measures has come at exactly the wrong time. In normal times, output follows a trend which is determined by supply influences—invention, natural resources, productivity and the size of the working population. These are the factors on which medium-term projections have been based; short-term "fine tuning" of the level of demand has been concerned only with correcting cyclical swings about this trend.

Now, however, the Review sees the situation as radically different. Our largely ineffective struggles with inflation during the eight years since the first Opec oil shock have depressed activity far below the potential readily available from our resources of capital and labour. On this view, deficient demand is now a medium-term problem.

The Review therefore urges a cut in cost-raising taxes. The same suggestion has occurred to many other analysts, ranging from the CBI leftwards. The novelty in the Review is the attempt to quantify the rewards over several years and to examine the arguments usually advanced against this course.

The projection is not altogether persuasive, for it shows the estimated rewards vary wildly on the basis of abstract and rather questionable assumptions about wage behaviour. On the other hand the objections are also cut down to size.

Endorsed

The Review is particularly hard on the assertion that workers have "priced themselves out of jobs" through excessive real wages. The figures show that the growth of real wages has been rather slow in recent years—and probably largely due to tighter monetary policies which raised the real exchange rate. The damage, if it is damage, was done in the 1960s, when take home pay rose by a fifth.

The argument that welfare benefits have reached a level which encourages idleness also emerges battered. The ratio of welfare to earned incomes has been falling quite steadily—and on some measures, rapidly—it peaked in the late 1960s. The Review does concede, however, that the combined cost of enhanced real wages and of welfare benefits and charges appears to have squeezed profits to an unacceptably low level. This argument also points to a cut in employers' national insurance contributions. The CBI could only applaud.

The only trouble with this analysis is that it seems to leave out most of the problems which have rendered economic management so baffling in the 1970s. Most notably, there is little attempt to ask why, if the Government's whole approach is so radically and tragically mistaken, it has been endorsed in general by so many other governments and international institutions.

Indeed, the Review, by assuming that we are not in danger of straining capacity seems to wish away the whole of the stabilisation problem which so preoccupies the world. It simply assumes, for no clear reason, that we have come through a violent storm into the doldrums, so that the problem now is to set more sail. Have conditions really become stable, almost overnight? It seems highly implausible.

Embroiled

The world's problem is partly that of a still unfinished adaptation to relative energy prices—which is why the Bank for International Settlements argues for real income restraints to make room for balance of payments correction and for higher investment. A point which the Review merely acknowledges in passing is that the energy crisis has rendered much capital plant obsolete. Some existing "capacity" is so much scrap metal, as Detroit could testify.

Above all, we are still embroiled in a world of violent financial instability, in which unprecedented swings in real exchanges and real interest rates disrupt business planning, and threaten weak economies with bankruptcy. This financial picture has no resemblance at all to the sullen stagnation for which the Review prescribes.

Much of the present painful readjustment round the world is an effort to avoid adding to the mountain of unstable debt which threatens to topple on us all. Its management and consolidation might be assisted by the advice of a new Keynes; it is hardly to be solved by the proposals of the old one to break a *deflationary* recession 50 years ago.