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13 July 1987

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## TREASURY ECONOMIC FORECAST

I enclose two copies of this year's Summer Forecast, one for the Prime Minister and one for Brian Griffiths. As usual, these copies are on a personal basis for the Prime Minister, Brian Griffiths, Nigel Wicks and yourself only.

R B SAUNDERS

## TREASURY ECONOMIC FORECASTING EXERCISE

## JUNE 1987 REPORT

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## TREASURY ECONOMIC FORECASTING EXERCISE

## REPORT BY EA AND PSF

## (1) INTRODUCTION AND SUMMARY OF MAIN RESULTS

The forecast covers the period to the end of 1990 (financial year 1990-91 for public finances). Table 1 summarises the results.

(a) Assumptions

- (i) Short term interest rates are set in order to keep the sterling index at 72 from now on, close to the present level and slightly above that at the time of the Louvre agreement. This involves short term interest rates rising gradually through the period. It yields a path for money GDP above that envisaged in the 1987 MTFS.
- (ii) The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the annual rounds of Ministerial discussions and on how the evolution of the economy will influence demand led public expenditure. (The annex to this paper summarises the assumptions on particular categories of public expenditure.)
- (iii) For the current financial year (1987-88) there is a forecast for the **PSBR** on the basis of existing tax rates and the best available assessment of the outcome for public expenditure. For the latter years - 1988-89 and 1989-90 - the forecast shows a very large cumulative fiscal adjustment if the PSBR ratios are set at 1 per cent and privatisation proceeds are assumed to be £5b. The forecast adopts the procedure used in the January forecast and assumes that half of the fiscal adjustment goes to reduce the PSBR (below the 1987 MTFS ratios) and half to reduce personal taxes.

(b) Main results

- (i) Both GDP and domestic demand in the UK are likely to grow more rapidly in 1987 than previously envisaged by the majority of forecasters, despite weaker growth in the other G7 economies. Growth of manufacturing output in the UK could be almost 5 per cent in 1987. Growth in 1987, clearly above the recent trend is

TABLE 1 : SUMMARY OF FORECAST

	<u>JANUARY</u> <u>1987</u>	<u>FSER</u> <u>1987</u>	<u>SUMMER</u> <u>1987</u>	<u>AVERAGE</u> <u>OUTSIDE</u> <u>FORECAST</u> <u>JUNE 1987</u>
<b>A THE WORLD ECONOMY</b>				
1. <u>GNP (MAJOR 7 EXCLUDING UK)</u> (per cent change on a year earlier)				
1986	2.6	2.6	2.5	
1987	2.9	2.6	2.3	
1988	3.0	3.0	2.8	
1989	2.9	3.0	2.8	
2. <u>DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK)</u> (per cent change on a year earlier)				
1986	3.8	3.8	3.7	
1987	3.3	3.0	2.6	
1988	3.1	3.2	2.8	
1989	2.8	3.0	2.8	
3. <u>WORLD TRADE IN MANUFACTURES</u> (weighted by UK market shares) (per cent change on a year earlier)				
1986	1.7	2.4	2.1	
1987	3.6	3.4	2.6	3.8
1988	4.1	4.1	3.2	4.2
1989	4.8	5.0	4.3	
<b>B UK ACTIVITY AND DEMAND</b>				
4. <u>GDP VOLUME (non-North Sea GDP in brackets)</u> (per cent change on a year earlier)				
1986	3.0(2.9)	2.6(2.7)	2.8(2.9)	
1987	3.1(3.4)	3.0(3.1)	3.9(4.1)	3.0
1988	2.5(3.2)	2.4(2.9)	2.3(2.8)	2.5
1989	2.4(3.0)	2.4(2.8)	1.7(2.1)	
5. <u>VOLUME OF DOMESTIC DEMAND</u> (per cent change on a year earlier)				
1986	3.3	3.2	3.5	
1987	3.4	3.5	3.6	
1988	2.6	2.4	3.3	
1989	2.4	2.2	2.0	
6. <u>UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS MILLION)</u>				
1986 Q4	3.14	3.14	3.14	
1987 Q4	2.85	2.88	2.73	2.95
1988 Q4	2.82	3.01	2.58	2.94
1989 Q4	2.73	2.94	2.61	
<b>C INFLATION AND MONEY GDP</b>				
7. <u>MONEY GDP (MARKET PRICES)</u> (per cent change on a year earlier)				
1986-87	6.6	6.1	6.3	
1987-88	7.3	7.5	8.8	
1988-89	7.8	6.4	7.9	
1989-90	7.8	6.1	7.1	

	<u>JANUARY</u> <u>1987</u>	<u>FSBR</u> <u>1987</u>	<u>SUMMER</u> <u>1987</u>	
8. <u>RPI (excluding mortgage interest payments in brackets)</u> (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	3.4(3.4)	
1987 Q4	4.4(3.9)	3.9(3.4)	3.8(3.6)	3.9
1988 Q4	4.9(4.6)	3.3(3.0)	5.1(4.4)	4.6
1989 Q4	4.9(4.7)	3.3(3.2)	4.2(3.9)	
<b>D <u>PUBLIC FINANCES</u></b>				
9. <u>PSBR - £ BILLION</u>				
1986-87	5.2	4.1	3.3	
1987-88	4.3	3.9	1.0	4.8
1988-89	2.2	4.4	0.8	4.9
1989-90	1.7	4.9	0.8	
10. <u>PSBR - % OF GDP</u>				
1986-87	1.3	1.1	0.9	
1987-88	1.0	1.0	0.2	1.2
1988-89	0.5	1.0	0.2	1.1
1989-90	0.4	1.0	0.2	
11. <u>ANNUAL FISCAL ADJUSTMENT - £ BILLION</u>				
1988-89	4.1*	3.2*	7.4*	
1989-90	1.9*	1.7*	1.1*	
<u>allocated to</u>				
(a) reducing personal taxes				
1988-89	1.9	3.2	3.7	2.3
1989-90	0.8	1.7	0.5	
(b) reducing PSBR				
1988-89	2.2	0.0	3.7	
1989-90	1.1	0.0	0.6	
*Assuming PSBR/money GDP ratio of 1 per cent as in 1987 MIFS.				
<b>E <u>MONETARY CONDITIONS</u></b>				
12. <u>INTEREST RATES (SHORT-TERM (PER CENT))</u>				
1986 Q4	11.2	11.2	11.2	
1987 Q4	11.0	10.3	9.5	8.9
1988 Q4	11.0	10.1	10.5	8.7
1989 Q4	11.0	9.7	10.5	
13. <u>MO</u> (per cent change on a year earlier)				
1986-87	4.6	4.3	4.3	
1987-88	5.6	4.0	4.3	
1988-89	4.1	3.4	4.0	
1989-90	3.6	3.0	3.4	
14. <u>EFFECTIVE EXCHANGE RATE (1975=100)</u>				
1986	72.8	72.8	72.8	
1987	68.7	70.3	71.7	70.6(Q4)
1988	67.3	69.3	72.0	69.0(Q4)
1989	65.3	67.3	72.0	

	<u>JANUARY</u> <u>1987</u>	<u>FSBR</u> <u>1987</u>	<u>SUMMER</u> <u>1987</u>	<u>AVERAGE</u> <u>OUTSIDE</u> <u>FORECAST</u> <u>JUNE 1987</u>
<b>F <u>TRADE AND CURRENT ACCOUNT</u></b>				
15. <u>VOLUME OF NON-OIL EXPORTS OF</u> <u>GOODS AND SERVICES (EXCL. ERRATICS)</u> (per cent change on a year earlier)				
1986	1.5	1.9	1.9	
1987	6.1	5.8	4.4	
1988	4.4	4.0	3.6	
1989	5.3	5.1	4.5	
16. <u>VOLUME OF NON-OIL IMPORTS OF</u> <u>GOODS AND SERVICES (EXCL.</u> <u>ERRATICS)</u> (per cent change on a year earlier)				
1986	4.8	5.5	5.4	
1987	8.5	6.9	3.9	
1988	2.4	1.9	4.7	
1989	2.9	2.7	3.5	
17. <u>CURRENT BALANCE</u> <u>£ BILLION</u>				
1986	-0.1	-1.1	-0.1	
1987	-3.1	-2.7	-0.5	-1.7
1988	-3.3	-1.7	-0.9	-2.6
1989	-2.8	-0.4	-2.3	

likely to be followed by a period of slightly lower growth, but the forecast level of real GDP in 1989 is still a little higher than set out in the MTFS.

(ii) RPI inflation is expected to be close to the FSBR forecast of 4 per cent in 1987(4), but to edge up during 1988, although the rise is less if mortgage interest costs are excluded. Some prices which are very demand sensitive, eg for construction, are likely to accelerate during 1987. The GDP deflator is forecast to rise by 5 per cent in 1987-88, rather more than envisaged in the MTFS. Both higher real growth and inflation contribute throughout the forecast period to faster growth of money GDP than set out in the MTFS.

(iii) Since the fall in the oil price in the first quarter of 1986 the current account has been in approximate balance, even though domestic demand and output in the UK have risen rapidly and the growth of world trade in manufactures has been relatively modest. The evidence of recent years suggests the possibility both that the effects of improvements in competitiveness may be larger and quicker acting than previously expected by us, and that previous estimates of trend loss of market share may be too pessimistic. The forecast has small current account deficits in the three years from 1987. Over these three years domestic demand in the UK slows down and world trade accelerates. Both of these developments benefit the current account. They are offset by the diminishing effects of last year's competitiveness gain and the initial effects of the gradual loss of competitiveness. Over the forecast period domestic labour costs rise a little faster than in the main competing economies.

(iv) The prospects for public finances are yet again better than in earlier forecasts because of higher tax receipts. The forecast envisages outturns for the public expenditure planning total in 1988-89 and 1989-90 that are respectively £5b. and £11b. above the current plans. About half of this forecast overspend is accounted for by social security and local authority current spending, areas over which central government has limited direct control. Although public expenditure in cash terms is forecast to be significantly higher than in the current plans both prices and activity are forecast to be higher than assumed in the PEWP/

MTFS. In real terms the level of public expenditure (GGE) is forecast to be a little below the level currently implied by plans (and the assumption on which they are based) in 1988-89 and much the same in 1989-90. The ratio of non-oil government revenues to GDP is higher than in previous forecasts, and North Sea revenues benefit from the higher oil price. Finally the forecast embodies better prospects for borrowing by local authorities following the recent low outturns and our review of their behaviour. Taken together these judgements on the prospects for public finances imply that if the PSBR were held to one per cent of GDP as set out in the 1987 MTFS the cumulative fiscal adjustment in 1988-89 and 1989-90 would be £8½b., as against the estimate of £5b. published in the MTFS.

- (v) The forecasts and policy assumptions for the UK and world economies imply a greater ex post tightening of fiscal policy in the UK than the rest of the Major 7 as shown by the general government financial deficit, the only reasonably comparable measure of stance available for all the developed economies.

**TABLE 2 : GENERAL GOVERNMENT DEFICITS AS A SHARE OF GDP (%)**

	1986	1987	1988	1989
UK*	2.9	2.0	1.9	1.7
Major 7 (less UK)	3.1	3.0	2.8	2.5

\*financial years

**(c) Risks**

- (i) The economy, which is currently very buoyant, could turn out to be **more cyclical** than it has been since the recovery began in 1981 or than currently forecast. If growth in the near future turns out to be even greater than forecast there is a greater risk of reduced growth later on. In addition the more buoyant the economy in the immediate future the greater is the chance that inflation in the short run will be higher than forecast.
- (ii) **Trade performance** in the last few years has been considerably better than experienced in the previous ten to fifteen years. The forecast has attempted to take account of this, but the judgements are very uncertain. More buoyant domestic growth could help bring about a marked worsening in the current account, particularly if large-scale stockbuilding occurs.



(iii) Past forecasts for public expenditure have been surprisingly accurate given the enormous uncertainties. (See tables 30 and 33.) On average the forecasters have underestimated government revenues more than expenditure. Nevertheless the favourable prospect for public finances and the fiscal adjustment depends crucially on the forecast for public expenditure in real terms not turning out to be an underestimate. The margins of error around the forecasts for public finances are very large.

## (2) THE WORLD ECONOMY

3. Following the oil price fall domestic demand in the Major 7 grew slightly faster in 1986 than in the UK. Major 7 GNP growth was, at 2½ per cent, over a percentage point lower than the growth of domestic demand because while import volumes grew strongly, at 9½ per cent, exports grew by only 1½ per cent. This poor net export performance in part reflected cutbacks in imports by OPEC and LDCs with financing difficulties. In addition, however, there was a large rise in the Major 7's real exchange rate. This resulted in a loss of world market share, with South Eastern Asian NICs being the principal beneficiaries. To a lesser extent than the NICs the UK appears to have improved its market shares at the expense of the rest of Major 7.

**TABLE 3 : MAJOR 7 (less UK) GROWTH AND INFLATION**  
(latest OECD\* forecast in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.5	2.3(2½)	2.7(2½)	2.8
Domestic Demand	3.7	2.6(2½)	2.8(2½)	2.8
Industrial Production	0.9	1.9(2)	3.6(3½)	3.4
Consumer prices	2.0	2.7(3)	3.0(3½)	3.3

\* OECD figures for all the Major 7

4. In 1987 the WEP envisages, along with other recent forecasts, a drop in the growth of Major 7 (less UK) domestic demand to a little over 2½ per cent. With a somewhat better outlook for Major 7 net

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exports GNP growth in 1987 is, however, not likely to drop much below the hardly spectacular rate of 2½ per cent recorded for 1986. The prospect is for a slight edging up of GNP growth in 1988 and 1989.

5. Recent movements in demand and output in the Major 7 have not been highly correlated with those in the various measures of world trade. In 1986 the effect of buoyant Major 7 imports on world trade was in large part offset by estimated further falls in OPEC imports and by very slow growth of imports by total developing countries. (As currently defined this group includes some important and prosperous countries, such as Taiwan.) For 1987 the forecast is for slightly lower growth for total world trade, but nevertheless at the same time for a slight pick up in growth of world trade in manufactures. This pick up in world trade growth continues in 1988 and 1989 as OPEC and NODC imports recover. For this forecast we have constructed a measure of total world trade in manufactures that includes estimates of exports by Newly Industrialised Countries (NIC's). (This measure has not been available in the past because of data deficiencies, not all of which have been overcome, and is still liable to significant measurement error.) Total world trade in manufactures continues to grow more quickly through the forecast period than developed countries exports of manufactures, reflecting the lagged effects of the Major 7 real appreciation.

**TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE**

(percentage change on previous year)

	1986	1987	1988	1989
<b>Total world imports</b>	5	3	4	4½
of which:-				
- G7	9	4	4	4½
- OPEC	-21	-15	2	4
- Non-OPEC developing countries (NODC's)	2	4	5	6
<b>Total world exports of manufactures (including NIC's)</b>	3	4	4½	5½
<b>Developed countries exports of manufactures weighted by UK market share (the conventional measure of UK weighted world trade in manufactures)</b>	2	2½	3½	4½

6. World commodity prices have been rising so far during 1987 from the historically low real levels recorded in the second half of 1986. The

forecast is for a further gradual rise in real non-oil industrial material prices. (Food prices will remain weak.) This together with the rise in the oil price that has already occurred will - for a given exchange rate - exert a modest upward pressure on UK inflation. Within the Major 7 the average rates of consumer price and wage cost inflation are likely to remain low, though a little above the rates recorded in 1986.

### (3) TRADE AND THE BALANCE OF PAYMENTS

7. The current account moved into deficit following the oil price fall at the beginning of 1986. The surplus in the first four months of this year - with exports remaining high and imports lower than in the second half of last year - produced a £½b. deficit in the current account in the year following the oil price fall. This was a much better outcome than the majority of forecasters expected.

TABLE 5 : UK CURRENT ACCOUNT (£BN)

	<u>Visible trade balances</u>			<u>Net invisibles</u>			<u>Current balance</u>
	<u>Manufactures</u>	<u>Oil</u>	<u>Other</u>	<u>Services</u>	<u>IPD</u>	<u>Transfers</u>	
1986	-5.4	4.2	-7.0	5.4	5.1	-2.3	-0.1
1987	-6.4	4.5	-6.4	5.7	5.5	-3.3	-0.5
1988	-8.2	3.4	-6.0	6.0	6.8	-2.8	-0.9
1989	-8.4	2.6	-6.2	6.5	7.1	-4.0	-2.4

8. The forecast judgement is that the improved trade performance since the early 1980s will continue. The implication of this is that at unchanged competitiveness and with demand growth at sustainable rates both at home and abroad the non-oil trade balance shows no tendency to worsen. In the past the presumption has been that the UK would over time lose share in developed countries' exports and experience faster rising import propensities than on average in other developed countries.

9. In 1987, the effect on the current account of the UK's relatively rapid growth of domestic demand and output is offset largely by the benefits of the 1986 competitiveness gain. In 1988 and 1989 UK growth gradually falls relative to overseas and this helps to offset the effects of the steady loss of competitiveness as domestic costs rise faster than those in other developed economies. (See Table 21.)

10. The structure of the current account continues to change over the forecast period. The balance of visible trade moves into greater

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deficit, while the services surplus rises slowly, as do net earnings from interest profits and dividends. These forecast changes in the components of the current account continue the trends of recent years. The forecast deficit on transfers fluctuates in line with the assumed timing of net EC contributions.

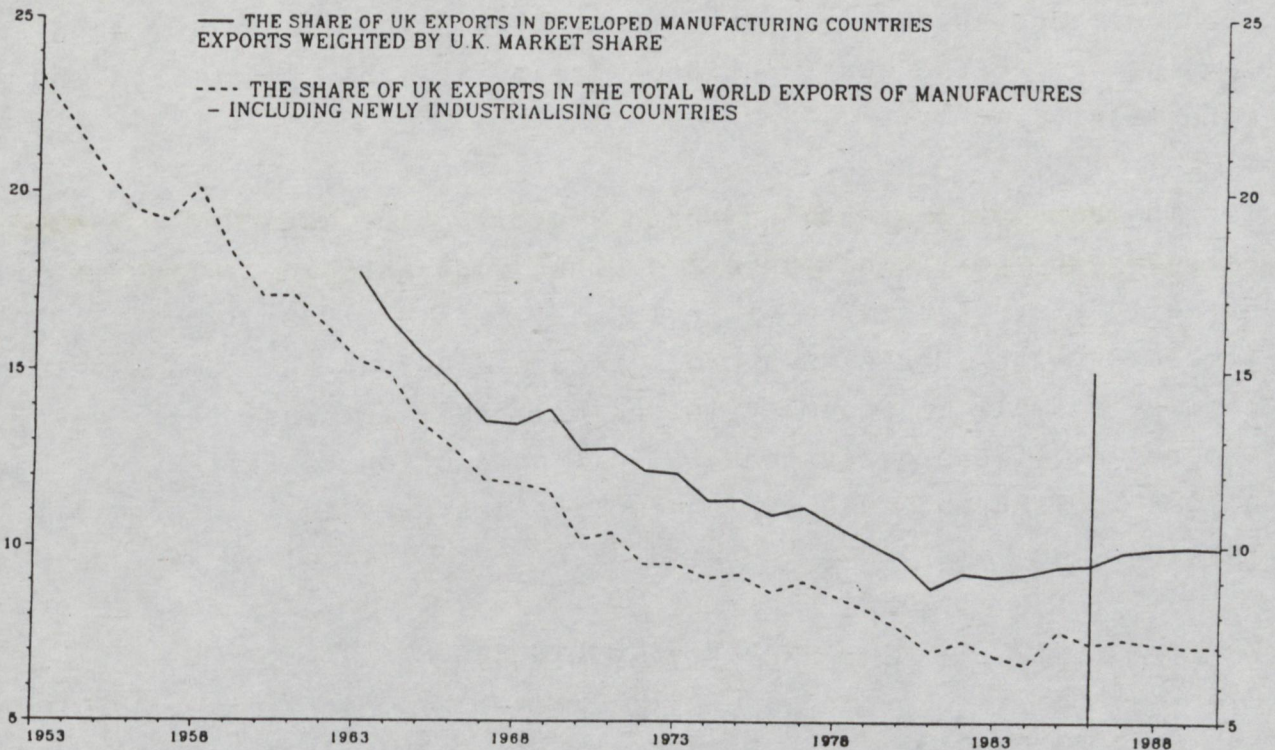
(a) Non-oil visible trade

11. The volume of manufactured exports, which fell back slightly in the first four months of this year from the high level at the end of 1986, is forecast to resume growing in the rest of this year. Growth is forecast to be rather faster than the relatively modest projected rise in developed countries' exports of manufactures (the conventional measure of UK weighted world trade) as a result of the UK's strong competitive position, which is reflected in the relatively buoyant order books revealed by the CBI survey. The UK is forecast to continue to gain market share on this measure in 1988 and 1989 - albeit less rapidly than in the recent past. (See Chart A.) The UK's share in total world exports of manufactures has risen less, because NICs' exports of manufactures (not included in the conventional measure) have clearly been rising fast in recent years. Nevertheless even on this wider measure of export market share there has clearly been a change in UK trade performance in the 1980s which the forecast assumes to be maintained. The forecast is for a very slight fall in the UK's share of the wider measure of world trade in manufactures that covers NIC's. (See Chart A.)

TABLE 6 : VISIBLE TRADE VOLUMES (PER CENT CHANGES)

	Manufactures			Non-manufactures		Terms of trade for nominal visible trade	
	Developed countries exports	UK exports	Domestic demand	UK imports	Exports		Imports
1986	2.1	2.7	1.8	5.2	9.1	7.4	-0.4
1987	2.6	6.5	6.4	6.8	-0.5	-1.3	-0.5
1988	3.2	4.3	2.9	6.9	0.1	-2.3	0.8
1989	4.3	4.8	1.5	4.3	2.4	2.0	-0.2

## SHARES OF UK EXPORTS IN THE VOLUME OF WORLD MANUFACTURING TRADE



12. The volume of manufactured imports fell sharply in the first four months of this year after the rapid rise in the latter half of 1986. The fall, however, may in part reflect residual seasonal influences (imports have fallen in the first quarter of the last four years) and a temporary slowdown in consumer spending. For the rest of the year the forecast has a relatively strong rise in imports as domestic demand and output grow strongly. The prospect for 1988 and 1989 is for imports to continue to grow relatively quickly, with the gradually worsening competitiveness offsetting the effects of declining growth of domestic demand for manufactures.

13. Non-manufactured exports and imports both grew relatively rapidly in 1986 partly as a result of exceptional trade in wheat and olive oil boosting both, and therefore leaving the current account virtually unaffected). These effects are currently unwinding, and both exports and imports are expected to be lower in 1987 than in 1986. In the rest of the forecast period, non-manufactured exports may rise gradually. Imports of food, drink and tobacco may also rise, but basic material imports may ease later as the growth of manufacturing output and stockbuilding slacken.

14. The non-oil terms of trade which worsened during 1986 as sterling depreciated, appear to be slightly firmer now as the pound's recent appreciation has more than offset some strengthening in commodity

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prices. Little change is expected in the forecast period with the exchange rate assumed constant and a weakening in world food prices tending to offset a continued rise in the price of industrial materials.

15. The assumption that the North Sea oil price stays at \$18½ until early next year and then remains constant in real terms yields a steadily rising sterling oil price from early 1988. The \$18½ price combined with North Sea production in 1987 at the same level as 1986 implies a small improvement in the oil trade surplus this year. The Department of Energy forecast NS oil production to fall by 6-7 per cent a year in 1988 and 1989, which implies a steady fall in the oil trade surplus.

TABLE 7: NORTH SEA OIL

	World oil price \$/barrel	N.Sea price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.3	9.7	126.9	4.2	7.5
1987	17.4	11.0	126.9	4.5	4.4
1988	18.2	10.7	117.2	3.4	4.7
1989	19.7	10.9	110.4	2.6	4.5

\* financial year totals

(b) Invisibles

16. The invisibles surplus, which is now estimated to have risen to £8.1b. in 1986, may fall slightly this year (more than accounted for by a larger net transfer to the EC), before recovering in 1988 and 1989. The surplus on services, which was depressed last year by a combination of fewer US visitors to the UK and increased spending abroad by UK tourists, may rise again this year as the benefits of improved competitiveness are felt. The improvements in the services balance in 1988 and 1989 would be even greater without the gradual worsening of competitiveness.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.4	-1.4	6.5	-0.7	-1.6	8.1
1987	5.7	-1.8	7.3	-1.5	-1.8	7.9
1988	6.0	-1.1	7.9	-0.8	-2.0	10.0
1989	6.5	-0.7	7.8	-2.0	-2.0	9.6

17. The net surplus on interest, profits and dividends which rose particularly sharply last year as sterling depreciated may show a small further rise this year, although higher North Sea debits will limit the improvement. North Sea payments abroad should decline in 1988 and 1989 as output falls. The pattern of transfer payments abroad is heavily influenced by net EC contributions, which are forecast to rise this year from the abnormally low level of 1986 before falling again sharply next year as large abatements are paid.

#### (4) DOMESTIC DEMAND AND ACTIVITY

##### (a) Personal income and expenditure

18. The consumer boom has flattened out since the late summer of last year even though personal incomes have continued to grow rapidly. The latest published estimates show a rise in the personal saving ratio from around 10 per cent in the third quarter of 1986 to around 12 per cent in the first quarter of 1987. Bad weather has undoubtedly depressed spending at times and more recently electoral uncertainties (and consequent uncertainties about future disposable income and tax rates) may have had some effect. Surveys, however, suggest consumer confidence remains high, and it seems likely that spending will rise relatively quickly over the remainder of 1987. The assumed allocation of half of the fiscal adjustment to cuts in personal taxes and the consequently fast growth in real personal disposable income keeps the growth of consumer spending high in 1988. The absence of a large cut in personal taxes in 1989 explains the fall from the high growth of the previous year.

19. Real personal investment in dwellings rose by 14 per cent in 1986 and is forecast to rise by almost 10 per cent this year. There has been a very strong supply response to the acceleration in house prices. Private housing starts rose by 10 per cent in 1986 and were about 20 per cent up between the first quarters of 1986 and 1987; in London private housing starts rose by almost 20 per cent in 1986 and by almost 80 per cent over the year to the first quarter of 1987.

20. The strong rise in both real housing investment and house prices means that the personal investment is rising fast in money terms at present. Personal saving is unlikely to rise to the same extent: indeed that part of personal saving that is accounted for by contributions into pension funds is likely to be depressed as funds continue to take measures to reduce existing surpluses. Thus the net

acquisition of financial assets by the personal sector, which virtually halved as a share of GDP between 1982 and 1986, is likely to fall further over the forecast period.

TABLE 9 : REAL PERSONAL INCOME AND EXPENDITURE

	Real Personal Disposable Income (RPDI) (Per cent change on previous year)	Real Consumers' expenditure	Real Investment in dwellings	Personal saving ratio (per cent)	Persons' net acquisition of financial assets (£bn)
1986	4.7	5.1	14.2	11.0	9.1
1987	3.7	3.7	10.9	11.0	7.9
1988	3.8	4.2	6.3	10.7	6.5
1989	2.8	2.7	4.3	10.8	6.8

(b) Company income and expenditure

21. Non-oil industrial and commercial companies' profits (net of stock appreciation) are estimated to have risen by around 20 per cent in 1986; but recorded expenditure by companies has remained very sluggish into the first quarter of 1987. Given the strength of the recent rise in output, a major upturn in spending is likely to occur soon and there is clear evidence from surveys that such an upturn is imminent.

TABLE 10 : PRIVATE SECTOR INVESTMENT INTENTIONS AND FORECAST

	(percentage change on previous year)			
	1986	1987	1988	1989
<u>Manufacturing*</u>				
June DTI survey	-4½	4	6	
HMT June forecast	-4½	4	5	2
<u>Private non-oil, non-manufacturing*</u>				
June DTI survey	0	10	7	
HMT June forecast	0	9	5½	-1

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

22. The latest DTI investment intentions survey points to a rise of about 8 per cent in non-oil industrial investment this year and a further similar rise in 1988. The rise in investment this year is expected to be particularly marked in commercial building work; and a big rise in this area seems to have been picked up in the construction output figures for the first quarter, even though it has not yet shown up in the figures for investment spending. Table 11 summarises the forecast for total investment.



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TABLE 11: GROSS FIXED DOMESTIC CAPITAL FORMATION

(per cent changes on year earlier)

Business	1986	1987	1988	1989
	-2½	4½	4½	1
of which				
North Sea	-14½	-18½	0	1½
Manufacturing	-4½	4	5	2
Other business	-½	6½	5	½
Domestic dwellings	9½	8	4	3½
General government	7	-2	-2	1½
<b>Total</b>	<b>1</b>	<b>4</b>	<b>3½</b>	<b>1½</b>

23. There are also indications from the CBI monthly trends enquiry of a prospective upturn in stockbuilding in manufacturing industry following six successive years of falling stock output ratios. The balance of respondents quoting their stocks of finished goods as more than adequate has been falling steadily over the last year, and in the June enquiry there was a balance of one per cent of respondents reporting stocks as less than adequate. This is likely to imply somewhat higher stockbuilding over the next year or so than seen recently; though with the continuing implementation of methods of reducing inventory requirements the forecast does not have a massive stockbuilding boom on the scale seen in previous decades.

24. The forecast recovery in companies' expenditure means that the financial surplus of companies is likely to fall a little from the large figures recorded in recent years, while industrial companies' borrowing requirement will rise sharply this year partly because of an unusually high level of investment overseas.

TABLE 12 : THE FINANCIAL POSITION OF INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of total income (per cent)		Rate of return on assets, non-oil ICCs (per cent)	Net acquisition of financial assets (£bn) (all ICCs)	Borrowing requirements (£bn) (all ICCs)
	Oil	Non-oil			
1973-85 average	2.1	10.6	5.5	1.8	3.3
1986	2.5	14.7	8	5.3	4.9
1987	2.8	15.0	9	4.7	10.7
1988	2.2	15.5	9½	5.0	7.0
1989	2.0	15.4	9	5.1	7.0

**(c) Aggregate demand and output**

25. Over the year to the first quarter of 1987 the average measure of GDP grew by about 3½ per cent, while the output estimate of GDP grew by 4½ per cent growth (4½ per cent non-oil). Within this growth of the output measure construction output grew by an exceptional 11½ per cent: a figure which may be subject to substantial revision. It is not possible to explain fully the recent strength of activity in terms of components of expenditure because of a large discrepancy between the expenditure estimate and the other estimates of GDP. An increase in the share of UK producers in domestic and foreign markets has made an important contribution to growth recently, and it is likely that as yet unrecorded rise in investment in the recent past may be partly responsible for the apparent buoyancy of domestic activity as consumption growth has appeared to moderate.

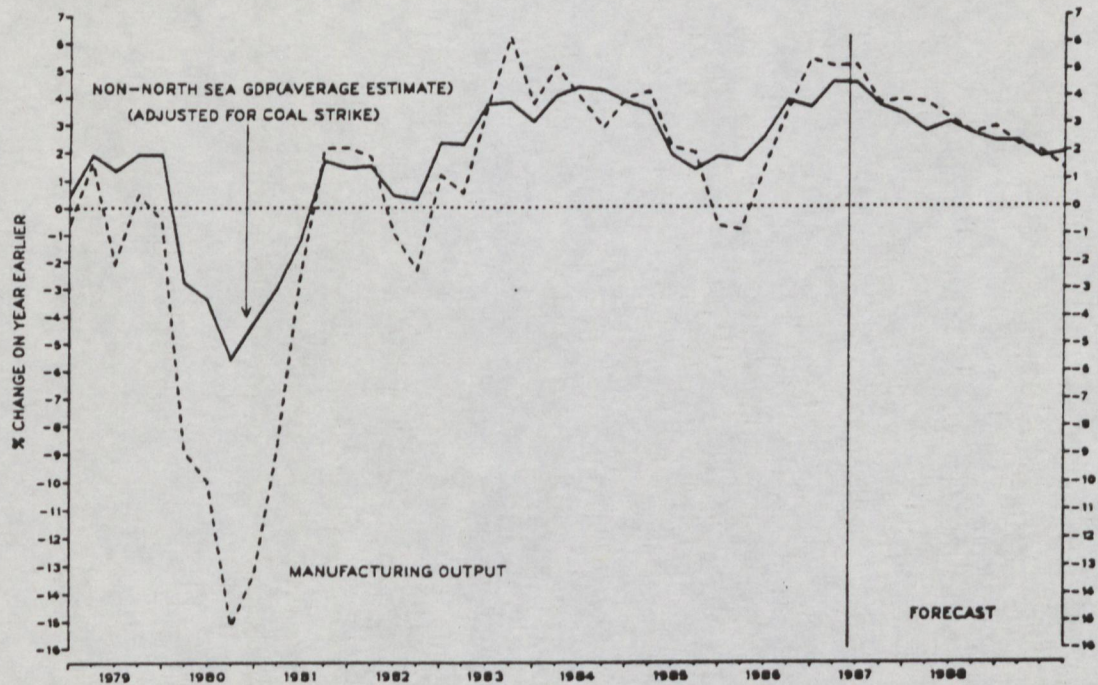
26. An important feature of the economy over the next two years is the forecast strength of company spending. During the upswing that has lasted since 1981 total company spending has so far remained relatively depressed, and the growth of demand has been weighted towards personal spending. With personal spending forecast to continue rising, the cyclical upswing in company spending in 1987 combined with a relatively favourable trade performance should mean overall GDP growth this year will be nearly 4 per cent. (This would be the highest GDP growth rate for a particular year since 1973.) Growth of manufacturing output could be even greater at just under 5 per cent. Investment should rise further in 1988, but because trade performance will not benefit to the same extent as this year from improved competitiveness. GDP growth will be lower than in 1987, though still close to 3 per cent. By 1989 there may be some cyclical down turn in company spending and GDP growth may be rather below figures recorded in the recent past, although the underlying growth of GDP would be similar to that recorded during the later part of 1985 and early 1986 (see Chart B). North Sea output is expected to decline quite sharply after 1987.

**TABLE 13 : EXPENDITURE AND OUTPUT**

	(percent changes on a year earlier)				
	<u>1986</u>	<u>1987(1)</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Domestic demand	3.5	(1.7)	3.6	3.3	2.0
Exports of goods and services	3.0	(9.1)	3.9	1.5	2.5
Imports of goods and services	5.8	(4.8)	3.3	4.8	3.4
Compromise adjustment*	0.3	(0.8)	0.1	0	0
GDP(A)	2.8	(3.4)**	3.9	2.3	1.7
Non-oil GDP(O)	3.0	(4.5)**	4.1	3.0	2.1
Manufacturing output	0.8	(5.4)**	4.8	3.3	2.1

\* Contribution to growth: \*\* Includes forecasters' adjustment to published figures for manufacturing output.

CHART B

**ANNUAL GROWTH IN GDP & MANUFACTURING OUTPUT****(5) INFLATION**

27. There has been little change to immediate prospects for RPI inflation since the Budget, although inflation in the fourth quarter of this year could even turn out just below the FSBR forecast of 4 per cent. It is hard to be at all confident about the effect of declining unemployment and rising capacity utilisation on inflation during the rest of the forecast period. The relative weakness of the world economic background - and therefore the modest recovery in commodity prices from their very depressed levels - should help to keep inflationary pressures in check, provided the sterling index remains firm.

**(a) Producer prices**

28. Even though manufacturers' costs are probably no higher now than they were at the end of 1985, manufacturing output price inflation has been edging up in recent months, and now stands at 4½ per cent. The balance of CBI respondents reporting expected prices increases has changed little over the last few months and is consistent with inflation staying at around its current level over the immediate future. The forecast has productivity growth returning to a more sustainable (though high by past standards) rate over the next year, and import prices will rise gradually, so that total costs in manufacturing may rise by 3 to 4 per cent a year from now on. Profit

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margins may rise further over the next year, but then stabilise or fall back a little as growth in manufacturing output slows. This could mean inflation remaining in the 4-5 per cent range this year and next, and falling below 4 per cent in 1989.

**TABLE 14 : MANUFACTURING COSTS AND PRICES**  
percentage change on a year earlier

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices
1986 Q4	1.3	- 5.6	0.2	3.9
1987 Q4	2.3	7.7	3.1	4.8
1988 Q4	4.6	1.1	3.2	4.3
1989 Q4	3.6	3.3	3.7	3.1

**(b) RPI**

29. As forecast at Budget time, RPI inflation is likely to peak in the summer months of this year and then fall back during the autumn. Inflation is likely to rise again after next year's Budget, assuming indexation of specific duties, and will rise further as this May's fall in mortgage rates drops out of the 12-month comparison. Retail price inflation may rise to around 5 per cent in the second half of 1988.

**TABLE 15: MONTHLY PATH OF RPI**

	Total RPI	RPI excluding mortgage interest payments
1987 May	4.1	3.8
June	4.5	3.8
July	4.6	3.9
August	4.5	4.0
September	4.2	3.7
October	4.3	3.6
November	3.6	3.5
December	3.5	3.4
1988 January	3.7	3.4
February	3.7	3.4
March	3.8	3.4
April	4.2	4.1
May	4.4	4.0
June	4.4	3.9

30. The contribution of **domestic fuel prices** to RPI inflation reaches its lowest point over the next few months as the recently announced fall in domestic gas prices is recorded in the RPI. By the second half of next year both electricity and gas prices will be recording increases.

**TABLE 16 : ASSUMED CHANGES IN DOMESTIC ENERGY PRICES**

	Electricity	Gas	Coal
1987		July 1987 - 4.5 per cent	November 1987 + 2.8 per cent
1988	April 1988 + 5 per cent	July 1988 + 7.7 per cent	November 1988 - 0.7 per cent

31. **Food** prices have recently been a little higher than expected at Budget time, with seasonal food prices almost 8 per cent higher than a year ago. Given reasonable crops and harvests, MAFF expect food price inflation to fall to around 2 per cent during the second half of this year, but it is likely to rise a little faster than this over the remainder of the forecast period. Nevertheless food price inflation should stay below the rate of increase of most non-food prices.

32. The **housing** component of the RPI will continue to rise at a fast rate. Although the current high rate of increase of house prices has a negligible effect on RPI inflation in the short run, the lagged effect of past house price increases, forecast increases in mortgage rates, and an increase of 7-8 per cent in Local Authority rates means that this component of the RPI may rise by almost 10 per cent over the year to the fourth quarter of 1988.

33. **Petrol** prices have yet to show signs of their normal summer rise. The forecast allows for a 9p rise in petrol prices in the near future: half in July and half in August. The price should then fall back again near the end of this year.

34. **'Other' private sector prices** have risen about  $3\frac{1}{2}$  per cent over the last year. (They would have risen some  $\frac{1}{2}$  per cent more but for the non-indexation of duties in the 1987 Budget.) They have risen by 1 per cent in the last two months, following a short period in which they rose by a little less than expected. The forecast has not given much weight to the most recent increases, and is for little change in the underlying rate of increase in prices over the next eighteen months

compared with the last year. As the economy slows down in 1989 the rate of increase of these prices is expected to fall.

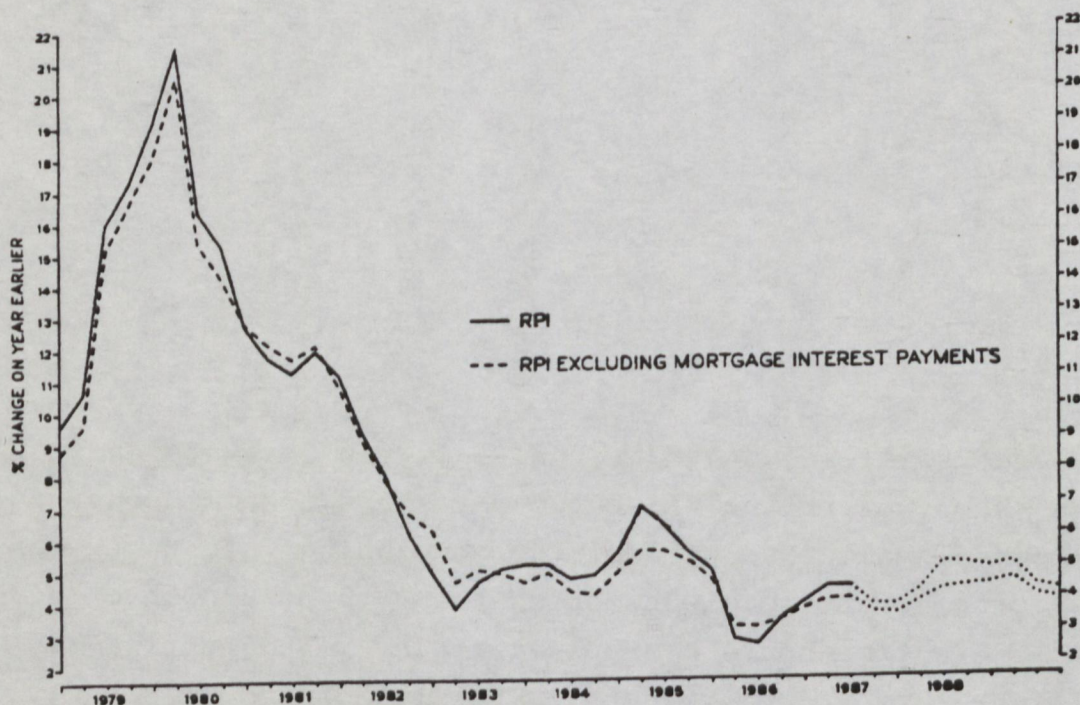
35. The forecast for the RPI is summarised in table 17 and chart C below.

TABLE 17 : COMPONENTS OF THE RETAIL PRICES INDEX  
Percentage changes on a year earlier

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	2.0	2.8	3.2
NI prices	3.6	1.8	5.6	3.5
Housing prices	7.1	7.2	9.2	6.9
Other prices	2.6	3.6	4.6	3.9
- of which petrol	-12.6	4.9	2.7	3.7
- other items	3.9	3.5	4.8	3.9
All items RPI	3.4	3.8	5.1	4.2
RPI excluding mortgage interest payments	3.4	3.5	4.4	3.8

CHART C

**RPI INFLATION**



(c) The GDP deflator

36. While the new RPI forecast for this year is marginally lower than the Budget forecast, the new forecast for the GDP deflator in 1987-88 is about  $\frac{1}{2}$  a percentage point higher than the Budget forecast. This increase to the GDP deflator reflects:

- slightly better terms of trade (a rise in export prices for given import prices raises the GDP deflator, other things being equal);
- higher forecast construction prices;
- a forecast small pick up in pay settlements in the latter part of this year.

Over the two following years the GDP deflator is forecast to rise even faster than projected in the MTFs, and significantly faster than consumer prices. The assumption of a constant exchange rate forecast contributes to this differential, because sluggish import prices do not directly benefit the GDP deflator.

**TABLE 18 : FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES**

	1986-87	1987-88	1988-89	1989-90
<b>MTFS</b>				
<b>total</b>	3	4½	4	3½
<b>non-oil</b>	6	4½	3½	3½
<b>June forecast:</b>				
<b>total</b>	3	5	5½	5
<b>non-oil</b>	5½	4½	5½	5

**(d) Earnings**

37. There are some signs that the fall in private sector pay settlements seen over the last two years has bottomed out, and that there has been a small rise since the beginning of the year. In addition rising overtime is boosting the rate of growth of earnings: the number of overtime hours per operative in manufacturing in April was the highest for many years. The Treasury model's equation for earnings points to quite strong upward pressure on earnings growth over the next two years, reflecting primarily strong company profits and the higher rates of retail and producer price inflation. Falling unemployment also has some influence, although this effect is quite weak. We have given some weight to the equation in the forecast.

38. The forecast has less of an acceleration in earnings than the model equation suggests, but allows for a small rise in settlements over the next year. Pay settlements are forecast to rise by about ½ a point on

average in the next pay round. While overtime in manufacturing may stay at a high level over the next year it is unlikely to rise much further: thus drift should be lower than it has been over the past year. The net effect may be that the rate of growth of private sector earnings will change little over the next pay round. By 1989 overtime will be falling and for that reason at least earnings growth should decline.

TABLE 19 : PRIVATE SECTOR SETTLEMENTS AND EARNINGS

	Payrounds		
	1986-87	1987-88	1988-89
Settlements	5	5½	5½
Effect of changes in overtime hours	+½	0	- ¼
Other drift	2	2	2
Increase in earnings	7½	7½	7½

39. The rate of growth of earnings in public services over the last year is coming out close to that for the private sector. Settlements have been higher than in the private sector - an estimated 7.5 per cent - for local authorities' employees, including teachers, in the current pay round and 6.5 per cent for central government employees; but drift has as usual been much lower than in the private sector: only about ½ per cent. (Chart D shows outturns and forecasts for the ratio of public service to private sector average earnings.)

40. It seems likely that local authority pay will rise significantly faster than private sector pay over the 1987-88 pay round. (Section 8 discusses the relative absence of effective constraints on LA's ability to finance higher current expenditure.) Local authority manual workers have already been offered (though not yet accepted) a deal believed to be worth about 10½ per cent. Groups such as the police are unlikely to fare badly, and there is the continuing effect of the teachers' settlement boosting earnings. Local Authority average earnings could easily rise by almost 9 per cent next year. The forecast assumes, however, that central government pay rises will again be held to 7 per cent on average - similar to this year's expected outturn.

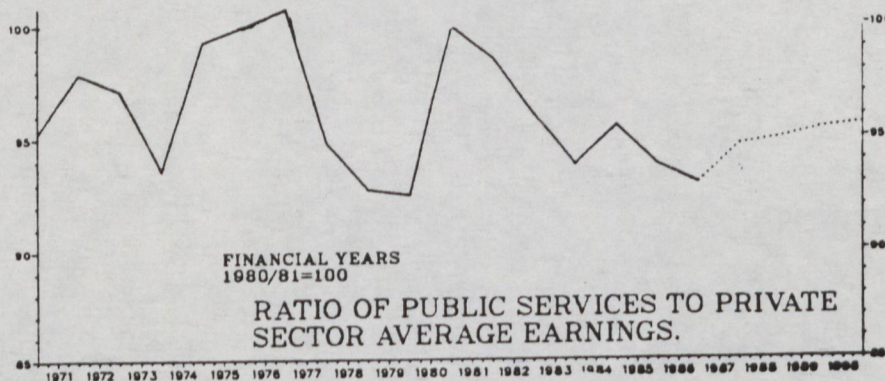


TABLE 20 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS  
percentage changes over pay rounds

<u>Payrounds</u>	<u>Central government</u>	<u>Local authorities</u>	<u>Private sector</u>
1986-87	7	8 (7)*	7½
1987-88	7	8½(7½)*	7½
1988-89	7½	7½(7½)*	7½

\*excluding settlements for primary and secondary teachers.

CHART D



(e) Labour costs

41. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that, while modest by past standards, are above those forecast for competitor economies.

TABLE 21 : LABOUR COST INCREASES IN MANUFACTURING  
(per cent increases on previous year)

	UK	Major 7 (less UK)
1986	4.3	2.1
1987	0.6	0.6
1988	3.6	0.5
1989	4.1	1.5

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

42. Output per head in manufacturing is currently estimated to have risen by a little over 6½ per cent over the last year. If, as the past record suggests, the published manufacturing output figures for the

recent past are too low the true rate of growth of productivity has been faster than this, probably in the range 7 to 8 per cent. Allowing for a large temporary cyclical contribution to productivity growth, the recent figures seem consistent with an underlying rate of growth of manufacturing productivity of around 4 per cent. (This figure was assumed in the MTFS calculations.) It is likely, as the cyclical contribution to productivity growth declines, that there will be a more moderate rate of recorded growth of productivity in manufacturing over the next year.

43. There is currently no information on what has been happening to employment outside manufacturing since the beginning of 1987. The large recent fall in unemployment may indicate strong employment growth, however, and relatively modest gains in productivity.

**TABLE 22: RECORDED GROWTH OF OUTPUT PER HEAD**

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	3½	¾	3½	4½
Non-manufacturing*	3	½	1½	1½
Non-oil economy	2½	½	1½	1½
Whole economy	2½	1	2	1½

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

44. New labour supply projections published in the May 1987 Employment Gazette show GB labour supply growing by around 440,000 in total over the three years to 1989, compared with 840,000 over the three years to 1986. The strength of economic activity in the forecast probably implies somewhat higher participation rates than Department of Employment have allowed for, and it is also quite likely that net inward migration will be higher than assumed in the population projection used by Department of Employment (both because of the relatively buoyant UK economy and because of developments in South Africa). The forecast allows for UK labour supply growth of around 660,000 in the three years to mid 1989.

45. The labour supply and productivity forecasts together imply non-oil productive potential growing by about 2½ per cent a year over the three

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years to 1989. For the whole economy, after taking account of the forecast decline in North Sea output, productive potential may grow by around  $2\frac{1}{4}$  per cent in 1987, and by around  $2\frac{1}{4}$  per cent over the following two years.

TABLE 23: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productive potential
1973-79	1	$\frac{1}{2}$	$1\frac{1}{2}$	$\frac{1}{2}$	2
1979-86	$1\frac{1}{4}$	$\frac{1}{2}$	$2\frac{1}{4}$	$\frac{1}{4}$	$2\frac{1}{2}$
1986-89	2	$\frac{3}{4}$	$2\frac{3}{4}$	- $\frac{1}{2}$	$2\frac{1}{2}$

46. The composition of output growth in 1987, with manufacturing output up by almost 5 per cent and quite possibly a still larger rise in construction output, holds out very favourable prospects for a further substantial decline in unemployment. The forecast has a fall in unemployment of around 350,000 over the next year, of which less than a half will reflect the effect of measures of various sorts. "Perpetual Restart" is not expected to have a large effect on the unemployment count (although it is impossible to be at all confident about its effects). The Job Training Scheme is assumed to build up as planned, but with a delay of one quarter as a result of lack of co-operation from Trade Unions. The forecast of slower growth and no new employment measures means little further fall in unemployment after the second quarter of 1988, in spite of the deceleration of labour supply.

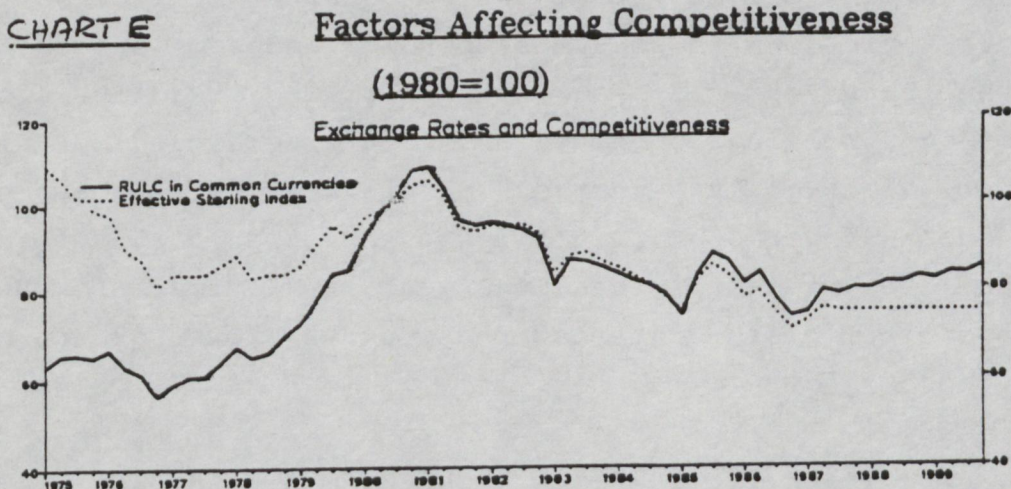
TABLE 24: CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemp- ment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 65	153
1986(2)-1987(2)	- 238	- 174	- 64
1987(2)-1988(2)	- 344	- 152	- 192
1988(2)-1989(2)	- 6	+ 20	- 26

## (7) FINANCIAL CONDITIONS

47. The WEP has a further decline in the effective exchange rate for the US dollar. This forecast fall is coupled with rising US interest rates, broadly offset by falls elsewhere. Other things being equal, this set of circumstances might be expected to lead to some upward pressure on sterling accompanied by downward pressure on UK interest rates. The prospect, however, is that UK inflation will tend to remain slightly above that of competitors and that the forecast loss of competitiveness will raise expectations of a deterioration in the current balance. Chart E summarises the forecast for the effective exchange rate and competitiveness as measured by relative unit labour costs.



**TABLE 25: EXCHANGE RATES AND COMPETITIVENESS**  
(average rates for calendar years)

	US dollar index (1975=100)	Sterling index (1975=100)	\$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.7	78.6	1.34	3.79	82.7
1985	140.7	78.2	1.30	3.78	84.4
1986	114.9	72.8	1.47	3.19	77.7
25 June	102.0	72.2	1.61	2.95	76.4
1987	101.1	71.7	1.62	2.91	75.2
1988	92.3	72.0	1.76	2.82	77.1
1989	86.9	72.0	1.86	2.73	78.6

48. The policy assumptions of maintaining a stable sterling effective rate of 72, implies a small rise in UK interest rates. The forecast

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has short-term interest rates beginning to rise from the present 9 per cent level in 1987Q4, reaching 10½ per cent by the latter half of 1988. This rise in interest rates is not sufficient to bring the growth of money GDP back to the 1987 MTFS path.

**TABLE 26: INTEREST RATES**

	3-month US interest rates	3-month world rates	3-month domestic LIBOR	Mortgage rate
26 June	7.2	6.3	9.1	12.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.2	6.2	9.5	11.4
1988-89	8.2	6.2	10.4	12.2
1989-90	9.2	6.5	10.5	12.3

49. M0 which fell slightly in the first quarter of 1987 as a result of the temporary slowdown in consumer spending and some special influences around the turn of the year, is now rising steadily. In the three months to June, holdings of notes and coin rose at an annual rate of 7 per cent although the year-on-year figures for M0 have been rather lower at about 4½ per cent. This is in the upper part of the target range and the forecast is that the year-on-year rate for M0 will stay around this until rising interest rates and a slower growth of consumer spending reduce growth.

**TABLE 27: MONETARY AGGREGATES AND CREDIT**

(per cent change on a year earlier)

	M0		M3	M4	Lending by banks and building societies
	MTFS range	Actual/ forecast			
May 1987	-	4.4	18.9	13.6	19.6
1986-87	2-6	4.3	18.7	14.9	19.0
1987-88	2-6	4.3	18.9	14.4	18.1
1988-89	1-5	4.0	13.9	13.1	16.5
1989-90	1-5	3.4	13.5	12.9	15.8

50. Broad money has continued to grow rapidly with M3 increasing by 19 per cent in the year to May, reflecting a strong rise in deposits held by industrial companies, building societies, and other financial institutions. Deposits held by persons have risen less rapidly than these although the increase has still been fast by recent standards as personal sector incomes and gross financial wealth have risen. The

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forecast is that M3 will continue to grow at a similar rate through the rest of this financial year, but will grow more slowly in 1988-89 and 1989-90 as incomes and wealth rise less rapidly, and as the growth of companies' liquidity slows. The growth of M4 which contains a greater proportion of personal sector deposits, rises less rapidly than M3.

51. Lending by banks and building societies which had risen by almost 20 per cent in the year to May, is forecast to rise by a similar amount for 1987-88 as a whole with a continued strong rise in lending to persons for both housing and other purposes as well as further advances to financial institutions, including security dealers. Lending may rise less rapidly in the rest of the forecast period as growth falls somewhat, interest rates rise and companies turn increasingly to securities markets.

52. The PSBR is assumed to be funded fully, but its low level - coupled with the assumption of £2b. a year receipts from National Savings - implies net gilt repayments of £1½b. a year on average in 1988-89 and 1989-90. There would still be considerable gross sales - averaging £8½b. in 1988-89 and 1989-90 as there are large maturities in these years. The need to finance a small emerging current deficit coupled with continued net capital outflows implies a forecast increase in non-residents' sterling bank deposits.

**TABLE 28: NET EXTERNAL CAPITAL FLOWS**

(£ billion)

	Direct invest-	Non-bank port- folio*	Banks foreign currency†	Banks sterling	Other	Official reserves	Balancing item	Current balance
1986	-5.6	-5.8	4.0	-0.4	1.5	-2.9	9.3	-0.1
1987	-9.3	2.3	4.1	6.0	5.1	-4.7	-3.1	-0.5
1988	-3.1	-1.5	0.7	1.4	1.4	0.8	1.0	-0.9
1989	-3.3	-2.0	1.0	3.8	1.9	0.0	1.0	-2.5

\* includes gilts

† includes securities

53. In the absence of any large changes in the current balance the external capital account is likely to be dominated by the need to finance a steady outflow of direct and portfolio investment. Net direct investment outflows which were abnormally high in 1986 as a result of mergers in the US, are boosted this year by BP's acquisition of Sohio, (largely financed by overseas borrowing, identified in the

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'Other' column in table 28). They are forecast to return to more normal levels in 1988 and 1989. Non-banks' net portfolio outflows which were exceptionally high in 1986 ahead of Big Bang, are projected to fall back to a level sufficient to maintain the share of foreign assets in institutions' portfolios. These outflows are forecast to be offset partly by non-residents' purchases of UK company securities. UK banks are forecast to maintain their share of total BIS banks' cross-border claims but to match this and their continued purchases of overseas securities by attracting foreign currency deposits from overseas. The remaining non-bank net capital outflows are assumed to be financed by banks attracting non-residents' sterling deposits, given forecast interest rates.

**(8) PUBLIC FINANCES**

54. Table 29 summarises the forecast and compares it with the FSBR numbers.

**TABLE 29: PUBLIC SECTOR EXPENDITURE, REVENUE AND BORROWING**  
(£ billion)

	1986-87		1987-88		1988-89		1989-90		
	Outturn	FSBR	June Fore-cast	Jan Fore-cast	FSBR	June Fore-cast	Jan Fore-cast	FSBR	June Fore-cast
General Government Expenditure	165	174	173	185	180	185	197	188	198
General Government receipts	160	169	172	184	178	187	197	187	201
Fiscal adjustment (assumed cuts in personal taxes)				2	3	4*	3	2	1*
GGBR	5	5	2	3	5	2	3	6	2
Public corporations' overseas and market borrowing	-1½	-1	-1	-1	-1	-1	-1	-1	-1
PSBR (per cent of GDP in brackets)	3½ (½)	4 (1)	1 (½)	2 (½)	4 (1)	1 (½)	2 (½)	5 (1)	1 (½)

\* The June Forecast also allocates £4bn and £1bn in 1988-89 and 1989-90 to reducing the PSBR below the 1 per cent ratio to GDP assumed in the FSBR.

**(a) 1987-88**

55. The forecast is that the PSBR in 1987-88 will again significantly undershoot the Budget forecast, by about £3b. About two thirds of the predicted undershoot is accounted for by central government own account

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borrowing, with the rest due to lower local authority borrowing. The error margins attached to PSBR forecasts made in the summer for the current year remain very large, only a little smaller than for the Budget forecast.

56. The main components of the £3b. reduction in the PSBR forecast for 1987-88, nearly all on the receipts side, are:

<b>Contribution to the change in the 1987-88 PSBR forecast</b>	<b>£ billion</b>
- higher North Sea revenues with the North Sea oil price averaging \$18 a barrel in 1987 and the £/\$ exchange rate remaining close to its current level;	- $\frac{1}{4}$
- higher non-North Sea corporation tax reflecting upward revisions to profits data for 1986 and higher dividend payments in 1987 (the latter generate higher ACT effectively bringing forward corporate tax payments);	- $\frac{1}{2}$
- higher stamp duty as a result of the buoyant housing and stock markets;	- $\frac{1}{4}$
- higher national insurance contributions reflecting higher money incomes and a new detailed assessment by the Government Actuary;	- $\frac{1}{2}$
- lower local authority borrowing in line with the low level of borrowing in 1986-87 and first two months of 1987-88;	-1
- improved ECGD trading position reflecting more refinancing of debt;	- $\frac{1}{4}$
- higher central government contribution to the planning total (excluding privatisation proceeds)	+ $\frac{1}{4}$
- lower central government dividend receipts partially offset by lower net debt interest payments	+ $\frac{1}{4}$
- higher privatisation proceeds in line with PE's latest assessment.	<u>-<math>\frac{1}{4}</math></u>
<b>TOTAL CHANGE IN PSBR FORECAST</b>	<b>-3</b>



**(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90**

57. With the MTFs assumption of PSBRs of one per cent of money GDP in 1988-89 and 1989-90 the forecast would have annual fiscal adjustments of over £7b. and £1b. respectively. For both these years the totals of expenditure and (pre-fiscal adjustment) receipts have been revised up from the stylised levels published in the 1987 FSBR. The forecast levels for public expenditure are close to those in previous internal forecasts. The forecast levels of revenue are higher (see tables 31 and 33). Part of the explanation for the better prospect for finances overall in these years is the higher level of economic activity and prices now, which helps to keep expenditure down and increase revenues. A slight downturn in growth in 1989 contributes to the lower scope for further fiscal adjustment in that year.

**(c) Public Expenditure**

58. The forecast of the planning total excluding privatisation proceeds in 1987-88 is nearly £1b. above the PEWP, a smaller projected overspend than in 1986-87. For 1988-89 and 1989-90 the forecast takes account of both the differences between the economic assumptions used in the PEWP and the economic prospects in the forecast, and other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. Privatisation proceeds of £5b. per annum have been assumed in both future years.

59. Table 31 sets out increases in programmes compared with the 1987 PEWP in terms of economic (rather than departmental) categories. In 1988-89 and 1989-90 about half the projected excess of the cash planning totals above the current plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control. Much social security expenditure is controlled to a great extent by the behaviour of the economy.

60. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings will rise

faster than those in the private sector in the 1987-88 pay round but in line with the private sector thereafter, plus an adjustment for this year's teachers settlement (see paragraph 39). To finance the forecast level of current expenditure LA rates increase over the next two years at about the same rate as in 1987-88. This forecast for local authorities takes account of the available evidence that suggests that the bulk of them will not face undue difficulties in financing levels of cash expenditure some way above current plans. The projected increases in local authority spending and income appear to be consistent with the local authority borrowing requirement remaining at or only a little above its low 1986-87 level.

61. The forecast overspend on public corporations EFLs is expected to be consistent with continued repayment of borrowing, ie with a negative PCBR.

TABLE 30: FORECAST CLAIMS ON THE RESERVE (tb)

	1987-88	1988-89	1989-90
Central government pay	0.6	1.5	2.8
Other central government current expenditure*	0.1	1.2	2.1
Net EC contributions	0.1	0.3	0.5
Social Security (including housing benefit)	0.7	2.0	3.9
Other central government	1.1	1.3	1.9
Local authority current	1.1	3.1	5.2
Local authority capital	0.2	0.3	0.4
Public corporations' EFLs	0.1	1.0	1.5
Privatisation proceeds	-0.3	-	-
1987 PEWP Reserves	-3.5	-5.5	-7.5
Overspending on PEWP planning totals	----- 0.2	----- 5.2	----- 10.8

\* includes MOD procurement

62. The large upward revision to the planning total forecast in 1988-89 since the Budget is largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is much

less than the cash increase. In real terms the planning total and GGE (see table 31) are much the same as, or lower than, earlier forecasts.

**TABLE 31: PAST AND CURRENT FORECASTS OF GGE INCLUDING PRIVATISATION PROCEEDS**  
(£ b.)

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current prices	Real Terms*
Jan 1986	164	157	171	157	181	158	-	-
June 1986	164	158	172	160	181	160	-	-
Oct 1986	165	161	173	162	183	163	195	164
Jan 1987	165	160	174	162	185	164	197	166
FSBR 1987	165	160	174	161	181	161	189	162
June 1987	165	160	173	160	185	162	198	165

\*1985-86 prices, using the GDP deflator

63. The ratio of GGE (excluding privatisation proceeds) in money GDP is forecast to fall in 1987-88 and 1988-89, but not in 1989-90. It is below or equal to the PEWP/MTFS paths, except in 1989-90 when it is above the MTFS, though not the PEWP, level.

**TABLE 32: RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (%)**

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44½	44½	44	42½	42½
1987 FSBR	44½	44½	43½	42½	41½
June forecast	44½	44½	43	42½	42½

### General government receipts

64. In the past year there have been consistent upward revisions to forecasts of non-oil receipts. In this forecast there is also a large upward revision to the forecast of oil revenues as a result of higher dollar oil prices.

65. Some of the upward revisions to non-oil receipts over the past year have been due to upward revisions to forecasts of money incomes and expenditure, but much the greater part has been due to higher receipts

for given incomes and expenditure - ie to higher effective tax rates. This time higher incomes and expenditure largely explain the higher non-oil receipts. Profits estimates for 1986 have been increased, producing more corporation tax in 1987-88 and the stock market has been stronger than expected so far this year leading to a higher forecast of stamp duty receipts. In addition the level of money GDP is forecast to be higher than in the FSBR and internal January forecasts throughout the forecast period. As table 33 shows the upward revisions to forecast receipts in 1988-89 and 1989-90 since January are in real terms slightly less than the upward revision to 1987-88.

**TABLE 33: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)\* (t.b.)**

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	151	167	153	178	156	-	-
June 1986	156	151	164	154	179	160	-	-
October 1986	156	152	165	154	181	161	196	165
January 1987	158	154	169	157	184	163	197	166
FSBR 1987	159	155	169	157	178	159	187	162
June 1987	160	155	172	159	188	164	201	167

\* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1985-86 prices.

66. Table 34 gives non-oil taxes and national insurance contributions (NICs) as a percentage of GDP. The non-oil tax burden is forecast to rise steadily at unchanged tax rates and allowances, ie before fiscal adjustment. The forecast fiscal adjustment is sufficient to reduce the tax burden in 1988-89 but it rises in 1989-90.

**TABLE 34: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP**

	1985-86	1986-87	1987-88	1988-89	1989-90
<b>FSBR</b>					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
<b>June Forecast</b>					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9

## ANNEX A:

## PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure for 1987-88 takes account of the latest information available, including GEP's monthly assessments. For 1988-89 onwards, the forecast reflects the extent to which the plans in the 1987 Public Expenditure White Paper are likely to be achieved given the forecast's assessment of economic developments and other pressures on expenditure. At the time the forecast was made no information on departmental bids for extra expenditure was available.

2. Detailed assumptions made were as follows:-

- (i) The ratio of Aggregate Exchequer Grant for local authorities to expenditure outturn in Great Britain in 1988-89 and 1989-90 will be a little below the forecast outturn for 1987-88, which preliminary indications suggest will be 47¼ per cent compared with 47¾ in 1986-87.
- (ii) An increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988.
- (iii) Privatisation proceeds of £5 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best guess of £5¼ billion is used.

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

	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>
<u>GDP deflator %</u>				
PEWP	3	3½	3½	3
Forecast	3	5	5½	5
<u>Money GDP</u>				
PEWP      £ billion	380.2	407.0	431.4	455.2
% increase	5½	7	6	5½
Forecast £ billion	382.6	416.2	449.1	480.8
% increase	6¼	8¼	8	7
<u>Unemployment (GB, narrow)</u>				
<u>million</u>				
PEWP	3.1	3.05	3.05	3.05
Forecast	3.03	2.7	2.5	2.5
			<u>Year to</u>	<u>Year to</u>
			<u>Sept 87</u>	<u>Sept 88</u>
<u>RPI %</u>				
PEWP			3½	3½
Forecast			4¼	5
<u>Short Term interest rates %</u>				
PEWP	10¼	10¼	8½	8
Forecast	10½	9½	10½	10½