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PRIME MINISTER

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JUNE ECONOMIC FORECAST

The general picture painted by this forecast is of an economy growing very strongly in 1987, perhaps too strongly, growing at a rate more in line with productive potential in 1988, and with somewhat lower growth in 1989. The forecast beyond the next 18 months is however very unreliable. There is no further progress on inflation, and, indeed, inflation is expected to rise to over 5 per cent in 1988, after a temporary dip below 4 per cent towards the end of this year and in the first few months of next. The forecast assumes that next year, unlike this year, specific duties will be indexed.

In more detail, output this year, excluding North Sea Oil, is expected to grow by 4.1 per cent, a full one per cent higher than expected at the time of the Budget. This results, in part, from a better performance on trade, with the current account deficit this year put at only £0.5 billion.

Consumers' expenditure is expected to rise by 3.7 per cent. Of particular interest is the forecast strong increase in investment, of 4 per cent in manufacturing and of 9 per cent elsewhere (excluding oil). Manufacturing output is expected to grow by just under 5 per cent.

Unemployment is expected to come down to about 2.75 million at the end of this year and to about 2.6 million at the end of 1988.

Strong growth is expected to have an effect on prices and costs. Total costs in manufacturing may rise by 3 to 4 per cent a year, and there are signs of an upturn in earnings growth, in the private sector, and particularly in local authorities, where average earnings "could easily rise by almost 9 per cent next year".

The forecasters expect out-turns for the public expenditure planning total in 1988/89 and 1989/90 that are respectively £5 billion and £11 billion above the current plans. About half of the over-spend is accounted for by social security and local authority current spending. But because inflation is expected to be higher, the level of expenditure in real terms is forecast to be a little below the level currently implied by the plans in 1988/89 and much the same in 1989/90. Revenues are extremely buoyant and the forecast is for a £7.4 billion fiscal adjustment in 1988/89. This is assumed to go half to reducing personal taxes and half to reducing the PSBR, giving a PSBR in 1988/98 of £0.8 billion following a forecast out-turn for this year of £1 billion.

Other points which are of interest include:

- (i) the forecasters draw attention to a much improved trade performance since the early 1980s, with a faster response to better competitiveness and, at worst, stability in our share of world markets;
- (ii) house building is responding strongly to higher house prices, with private housing starts up by about 20 per cent between the first quarters of 1986 and 1987; in London private house starts rose by almost 20 per cent in 1986 and by almost 80 per cent over the year to the first quarter of 1987;
- (iii) higher electricity and gas prices are expected in the second half of next year;
- (iv) the Treasury expect labour supply growth of around 660,000 in the three years to mid-1989 (put higher than a Department of Employment forecast because of the effects of strong growth) compared with 840,000 over the three years to 1986;

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- (v) exceptionally large direct investment overseas is forecast this year, dominated by BP's acquisition of Sohio.

Inflation and cost growth must be a central cause of concern in this forecast. This puts me in mind of your discussion with Sir Alan Walters about how core inflation in this country can be further reduced. But this is not, at present, a question to raise with the Chancellor.

DW

D.R.N.

17 July 1987

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