57a-c

PRIME MINISTER

BILATERAL MEETING WITH THE CHANCELLOR

At your bilateral on Monday the Chancellor would like to discuss the Treasury's latest economic forecast. I attach the relevant papers:

A. a covering minute;

B. a table showing the basics of the proposed published forecast; and

C. the central forecast itself.

The main difference between B (published forecast) and C (central forecast) is that B projects higher GDP growth of 0.5 per cent in 1991 versus nil growth in the central forecast. This in part is generated by higher exports: so the balance of payments deficit is lower also (-£10bn to -£12bn rather than -£12.5bn).

Central Forecast

You need to read the opening chapter of the central forecast in full. Also worth a glance are chapter 4 on the company sector; chapter 5 on trade; and chapter 6 on prices. And chapter 8 explains the prospective deterioration in public finances.

You are already aware of the general pattern. In 1991, there will be broadly zero growth; inflation will fall back to 5.5 per cent in 1991 Q4; the public finance position will deteriorate; and the balance of payments deficit will be reduced to -£12.5bn. The picture is a little better in 1992: higher growth is forecast (+ 2.75 per cent); inflation is projected to come down a little further (5.25 per cent in 1992 Q4); but the balance of payments deteriorates (- £16.75bn), as do public finances.

At the discussion, you will want to focus on what might go wrong. There are two main downside risks.

- that underlying inflation might remain stubbornly high throughout 1991 - there are dangers of higher than projected interest rates; a fall in sterling; and higher wage settlements;

b

- that the unprecedented company sector financial deficit will lead to a sharper cut back in their spending next year and thus lower economic activity, and risk of recession.

You can probably best probe both issues by questioning some of the critical assumptions in the forecast.

i) Exchange Rate. Sterling is assumed to fall only from the current Dm 2.94 to Dm 2.89 by 1992 Q4. One must question whether such a very modest depreciation of the exchange rate would be consistent with the economic fundamentals - persistently higher inflation than other European countries; the continuing uncompetitiveness of the UK manufacturers; and the deteriorating balance of payments. If the market senses that the UK has a fundamental imbalance, then the exchange rate may well fall. Or, if it is to be sustained, interest rates may have to be maintained at a higher rate than in this forecast. Either course would lead to higher inflation etc.

ii) Wage Settlements. The forecast appears to assume that wage settlements in the private sector will stick at around 10 per cent until around mid-1991. They are then projected to moderate quickly. Yet the rise in unemployment up to 1992 Q4 remains relatively modest and cost factors (eg oil prices, though see iii) below), are pushing inflation up. Will market forces be sufficiently strong to prevent continuation of wage settlements at around 9 per cent? If not, that could prolong higher inflation - and lead to a sharper, later downturn.

iii) Oil Prices. Clearly the course of these depends on the Gulf. But oil prices are projected to be nearly 50 per cent higher over the next year than in 1989. There are risks in either direction. What is the sensitivity of the forecast to varying the assumptions?

You might also like to question one or two elements of the forecast itself.

a) Chart 4.3 illustrates the continuing huge financial deficit in prospect for the corporate sector. There is an assumption that industry will go on being prepared to finance this large deficit. Yet its size is unprecedented; and too much weight should not be placed on the advantages of de-regulation in securing access to supporting finance. It is quite possible that industry will react to the deficit not by financing it in imaginative ways but by cutting it back. That in turn would suggest a much sharper cut in business investment than projected (the figures suggest that investment will be 20 per cent higher than it was two years ago). And there could also be more substantial destocking. Both would lead to a sharper downturn than projected.

b) The inflation forecast in table 6.3 shows both headline and underlying inflation staying high until March at least. Progress depends upon cuts in interest rates feeding through into lower mortgage payments and lower wage settlements. The latter may not be achieveable if sterling comes under pressure.

c) The report makes clear that the UK will face weak growth in world trade next year, with a 15 per cent decline in competitiveness. No improvement in competitiveness is projected thereafter. World trade growth is not strong in 1991 or 1992. The UK trade position could show a poorer export performance and greater deterioration than indicated in the tables.

d) Finally, the ratio of GGE (excluding privatisation proceeds) to GDP is forecast to rise next year. Also, to the extent that industry does cut back more than expected, there could be a fall in tax revenues. So it may not be a question of the public sector being more or less in balance in 1991-92; instead it could be a return to a borrowing requirement.

BHP

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