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Dear Andrew

The Prime Minister will wish to be aware of the economic assumptions which the Chancellor is proposing for public expenditure in the years 1985-86 to 1987-88. Most will be published in the Autumn Statement, the Government Actuary's November Report and the next Public Expenditure White Paper.

For the Autumn Statement the main assumptions are:-

	<u>Unemployment</u>	<u>Inflation</u>	<u>Average Earnings</u>
	(GB, narrow, millions)	(per cent rise in RPI, year to May)	(per cent rise, underlying year on year)
1984-85	3.0 =	-	7½* =
1985-86	3.0 =	4¾ =	7* =

(*These figures reflect "underlying" increases which take no account of the impact of the miners' dispute. The miners' dispute will probably reduce the 1984-85 figures to about 7 per cent and raise the 1985-86 figure to 7½ per cent.)

The figure for unemployment in the current financial year 1984-85 should not in itself cause much surprise. The total, on the definition used by the Government Actuary (GB, excluding school leavers and temporarily stopped), stood at nearly 3 million on a seasonally-adjusted basis in September. So the assumption implies, broadly, little change over the next few months. But it is of course higher than the figure of 2.85 million for 1984-85 which was published in the February 1984 PEWP and repeated in the July Report of the Government Actuary.

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For 1985-86, projections are inevitably more uncertain. But it would seem unwise to base further expenditure projections on an assumption that unemployment will start falling soon. The proposed figure of 3.0 million for 1985-86 is consistent with little net movement through the year.

On inflation, the last published figure of $4\frac{1}{2}$ per cent for the RPI increase up to the end of 1984 now looks a little optimistic. It is however likely to be much nearer to the eventual outcome (probably about $4\frac{3}{4}$ per cent) than commentators thought at Budget time. The likely overshoot is more than explained by the rise in mortgage interest rates. It is possible that the 12-month figure could rise again early next year to about 5 per cent, reflecting the path of the RPI through last year, but the underlying path should still be downward. The proposed assumption that the 12-month increase will be about $4\frac{3}{4}$ per cent next May would be consistent with these general trends.

There are some complex presentational issues connected with the assumptions about increases in average earnings. These are not of great importance to the public expenditure projections, but are needed by the Government Actuary to forecast income from National Insurance Contributions.

The earnings figures for 1984-85 will be heavily influenced by the effects of the miners' dispute. Even on the assumption that the strike is settled by the end of the year the simple loss of miners' earnings during the dispute will reduce the average increases for the financial year by about $\frac{2}{3}$ per cent. Thus, an "underlying" increase of about $7\frac{1}{2}$ per cent will reduce to just under 7 per cent. In 1985-86, we would get the opposite effect: taking a reduced 1984-85 level as "base" the recorded increase between the years would be raised by about $\frac{2}{3}$ per cent. Although some reduction in "underlying" increases is to be expected between the years, the relevant figures would then look like an increase from 7 per cent to $7\frac{1}{2}$ per cent.

To avoid this presentational difficulty without distorting the Government Actuary's calculations, the Chancellor proposes to ask him to give greater prominence in his explanation about the figures to an "underlying" reduction from about $7\frac{1}{2}$ per cent to about 7 per cent than to the actual figures. In smaller print, qualitative mention will be made of the impact of the miners' dispute and of the figures of 7 per cent and $7\frac{1}{2}$ per cent respectively which have actually gone into his forecasts.



Later years of the Survey

Assumptions are also needed for the later years in the Survey period. Those on unemployment and prices have in previous years not been published until the Public Expenditure White Paper. This year, they might be revealed earlier if total expenditure figures are to be provided. The proposed paths are as follows:

	<u>Unemployment</u>	<u>Inflation</u>	
		<u>RPI</u>	<u>GDP Deflator</u>
	(GB, narrow, millions)	(per cent rise in year to May)	(per cent rise)
1984-85	3.0	(5.1)	4 $\frac{3}{4}$
1985-86	3.0	4 $\frac{3}{4}$	4 $\frac{1}{2}$
1986-87	3.0	4	4
1987-88	3.0	3 $\frac{1}{2}$	3 $\frac{1}{4}$

The assumption of a flat path for unemployment after a recent rise is fairly conventional. The last set of published figures showed unemployment staying at 2.85 million for the years 1984-85 to 1986-87. Reflecting the increases that have actually taken place this year, the proposal is now to show a level of 3.0 million for all years.

On the RPI, and GDP deflators the figures are likely to cause no surprises. On the RPI no change is proposed for May 1986 from the figure of 4 per cent shown in the last PEWP. A further deceleration to 3 $\frac{1}{2}$ per cent is assumed for the year to May 1987.

Yours ever
David

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