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FROM: TERRY BURNS
30th June, 1982.

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

A fairly bland account but you will be interested in TB's policy comments. JCRD 9/5.

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JUNE 1982 ECONOMIC FORECAST

You have received the latest forecast. This does not involve much of a revision compared to the MTFS figures although for this year both output growth and inflation are now expected to be lower. Although the shape of the forecast is essentially the same it does raise some interesting issues both in relation to the behaviour of the economy and as a base to examine some policy implications.

The Outlook

2. After recovering from its low point in Spring 1981 output growth has been hesitant over the past six months or so. A number of factors seem to be involved:

(i) World output is lower than expected in the MTFS. Despite some beneficial effects from lower inflation and lower world commodity prices the continuation of high real interest rates seems to have had an important adverse effect. UK exports so far this year have been lower than expected, partly because of weaker world activity.

(ii) The sharp rise in UK interest rates last September seems to have had an impact on domestic activity as well as contributing to recent better inflation.

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(iii) Fiscal policy has been tighter than expected in the March 1981 budget. The nominal PSBR in 1981-82 turned out to be almost £2b. less than expected; in addition there was a higher than expected rate of inflation in Autumn 1981. When combined these indicate some tightening of the fiscal policy stance last Winter.

3. A resumption of modest recovery is expected as the factors mentioned above are reversed to some extent. Although we do not expect a sharp recovery of world output there should still be a significant improvement on last winter's performance. In the UK interest rates are lower; the fiscal position in 1982-83 should be easier, particularly after allowance for the lower inflation rate and the distortions of the civil service strike. The forecast does not show a rapid recovery; this reflects the slow world recovery, high real interest rates, a continuing low level of profitability and competitiveness, and the continuing need for inflation to adjust within the financial framework.

4. Inflation - particularly as measured by the RPI - has fallen faster than expected since the budget. To a large extent this is because of a better performance of administered prices rather than private sector prices. Even so there are clear signs that inflation will continue to perform well. Commodity prices are weak - import prices and wholesale input prices have been relatively stable in recent months. At the same time market pressures on margins remain acute and labour costs have been rising slowly. The forecast shows a gradual reversal of declining inflation from mid 1983. Of course the timing, and the extent of this is highly uncertain but there are a number of reasons why inflation may move up again at some stage over the next 18 months.

Not shown by Bank forecasts

(i) World recovery is likely to bring some reversal of the recent steep fall of commodity prices.

(ii) An exchange rate fall is more likely than a rise.

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(iii) Earnings growth could also rise as recovery emerges.

(iv) Productivity growth cannot be expected to continue at recent rates.

(v) Profit margins may improve with a recovery of demand.

At present the reversal nature shown in the forecast does not look serious (unless the exchange rate was to fall sharply), and it is possible that any increase could be from a lower base than shown in the forecast if pressures on world prices continue to be as strong as in recent months.

5. The sector flows show some improvement in the overall balance of the company and personal sectors although there is a substantial way to go before a satisfactory position is restored. The personal sector has been squeezed over the past couple of years to some extent and any improvement immediately ahead is likely to rely upon personal income tax reductions. However the past squeeze should not be exaggerated. Although settlements at the beginning of the last two pay rounds have been well below the going inflation rate by the end of the pay round earnings growth has been about the same as the (falling) inflation rate. The fall in real after tax take home pay is in large part due to the failure to index allowances in 1981 rather than because earnings growth has fallen significantly below the inflation rate. And the decline in real personal disposable income still does not offset large increases that took place between 1978 and 1980. Consumption is expected to remain broadly constant as the savings ratio declines.

6. Companies remain under pressure. There has been an improvement taking place in real disposable income of companies but there are still adverse pressures from a low level of demand and difficult competitive pressures which in turn squeeze profit margins. The growth in company incomes is expected to be able to finance a reasonable recovery of fixed investment and some restocking without any further major labout shedding (although unemployment may go on

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rising) but profitability rates still remain low compared even with 1979, itself lower than most earlier years.

7. Monetary conditions remain relatively tight, although there continues to be some difficulty in interpreting the monetary aggregates. The prospect is that even with some modest reduction in interest rates the aggregates as a whole should be consistent this year with the target range; but there is still the puzzle of high continuing bank lending and the uncertainty of the implications of the build-up of broad monetary aggregates over the past two years. We are likely to continue to have difficulty in interpreting the significance of these developments.

Some Policy Issues

8. The impact of the level of world activity, and in particular the United States is of considerable importance. It has become familiar ground to criticise the balance of fiscal and monetary policy in the US. However increasingly it appears to me that the overall pressure of policy has been excessive. If we were to apply the same criteria that we do in the UK we would conclude that financial conditions were very severe; a high and rapidly appreciating real exchange rate; lower inflation; exceptionally high real interest rates; and nominal GDP growth down to about 5% per annum. There must be a suspicion that US monetary indicators are giving a false reading just as our own wide aggregates did in 1980. The uncertainty of interest rates may be encouraging a substantial movement into short-term assets and so distorting the monetary aggregates. Overall the result may be that the monetary targets are too tight. There are clearly major political problems in the US in relation to the balance of policies but there must be an increasing danger of a combined excessive overall pressure of policy that will ultimately lead to a reversal of policies. Such a result could well undo a lot of the disinflationary benefit that has been achieved.

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9. In the UK it is difficult to make a case for Autumn measures to relax fiscal policy on the basis of the revisions to this forecast. On the measures we tend to use fiscal policy is expected to be easier in 1982-83 than last year, particularly after adjusting for the civil service strike. And the new forecast is reasonably close to the budget figure. The forecast suggests only very limited scope for real tax cuts in the 1983 budget and any substantial additions to public expenditure could easily undo that scope.

10. It is important to try to maintain our independence from US interest rates. We have seen the effect of a sharp rise in interest rates last Autumn and at the moment there is no domestic monetary argument for higher short term UK interest rates. As we have said in recent minutes to the Prime Minister some reduction would seem more appropriate given monetary behaviour over the past six months - particularly the narrow aggregates. Because the markets think we have an exchange rate target of around 90 any tendency for sterling to fall as a result of higher US interest rates could lead to market pressures for a rise in UK interest rates. It may be necessary to tolerate some modest depreciation of the effective exchange rate as a price of gaining some independence from US interest rates. The effect of tighter US policies in reducing world prices could neutralise much of any potential inflationary effects from a lower level of sterling. Although it would be dangerous to accept a sharp currency movement at this stage, given the policies that are being pursued in the US we must be careful that we do not fall into the opposite trap of becoming locked into an unchanged effective exchange rate when domestic conditions are becoming very tight. A similar approach by other European countries would of course be very welcome.

TERRY BURNS