SECRET A 9

PRIME MINISTER 17 October 1986

THE ECONOMY

All the indicators suggest that the British economy is in an accelerating boom - rising inflation, increasing wages and public expenditure, falling unemployment, a growing balance of payments deficit, upward pressure on interest rates and downward pressure on the exchange rate.

We set out below some questions to guide your discussion with the Chancellor.

What is the state of the world economy?

Growth is faltering this year (2.6% for the big seven, compared with 3.4% forecast at budget time). Commodity prices are still very depressed and the world banking system shaky. Consumer prices in Japan and Germany are lower than a year ago. Our exchange rate will carry on falling if we run a much looser policy than the rest of the world.

What is the performance of the real economy in Britain?

Real GDP has consistently grown at between 2½-3% per year since 1981. The Treasury forecast that adult unemployment will be about 380,000 lower at the end of 1988 than now. The boom may now be so strong that it would not be aborted by some further tightening of financial policy. Indeed, lack of confidence in the firmness of our financial policy may be the most important threat to the real economy.

What is the underlying British inflation rate?

The inflation rate was 3.4% at the last election. It has fallen below that because of the collapse of commodity

prices. But the underlying rate is rising. Even the Treasury are forecasting a rate of 4.1% by the end of 1987 and some City forecasters would go much higher. We cannot take the risk that it will be higher at the next Election than at the last.

What is the stance of monetary policy?

Every monetary measure is looser than six months ago (see Annex A). MO is accelerating (see Annex B). The growth rate of £M3 is now running at 18.25% compared with the 11 - 15% target range (see Annex C).

What is the state of fiscal policy?

Fiscal policy looks loose as well. This year's PSBR is now expected to be about £8.5bn rather than the £7bn forecast. The general Government financial deficit was down to 2.75% of GDP in 1985. The Treasury now expect it to rise to 3.25% in 1986 and 3.5% in 1987. The trend in the other main economies is in the opposite direction.

What is happening to the exchange rate?

The sterling index has fallen 17% since the second half of 1985. The Treasury attribute 10% of this to the fall in the oil price and the remaining 7% to domestic monetary conditions, the weakening balance of payments etc. Annex D shows that the recent falls in the exchange rate have occurred despite a strengthening in the oil price.

SECRET

Where do we go from here?

We suggest three rules of the road:

(i) Interest rates have to be used resolutely to control narrow money. They may have to be raised again soon.

(ii) Even if narrow money comes back under control the exchange rate may nevertheless fall again. This could be because of a weakening oil price in which case it has to be accepted as reflecting a change in the value of an important national asset. If, as an election approaches, the exchange rate falls for political reasons, we should also accept that and pin responsibility for higher inflation on the Opposition. Higher interest rates cannot compensate for fundamental political uncertainty.

(iii) On present indications, we very much doubt if it would be prudent to cut taxes in the next Budget, so expectations of tax cuts must be dampened down.

BG.

David Willetts

BRIAN GRIFFITHS

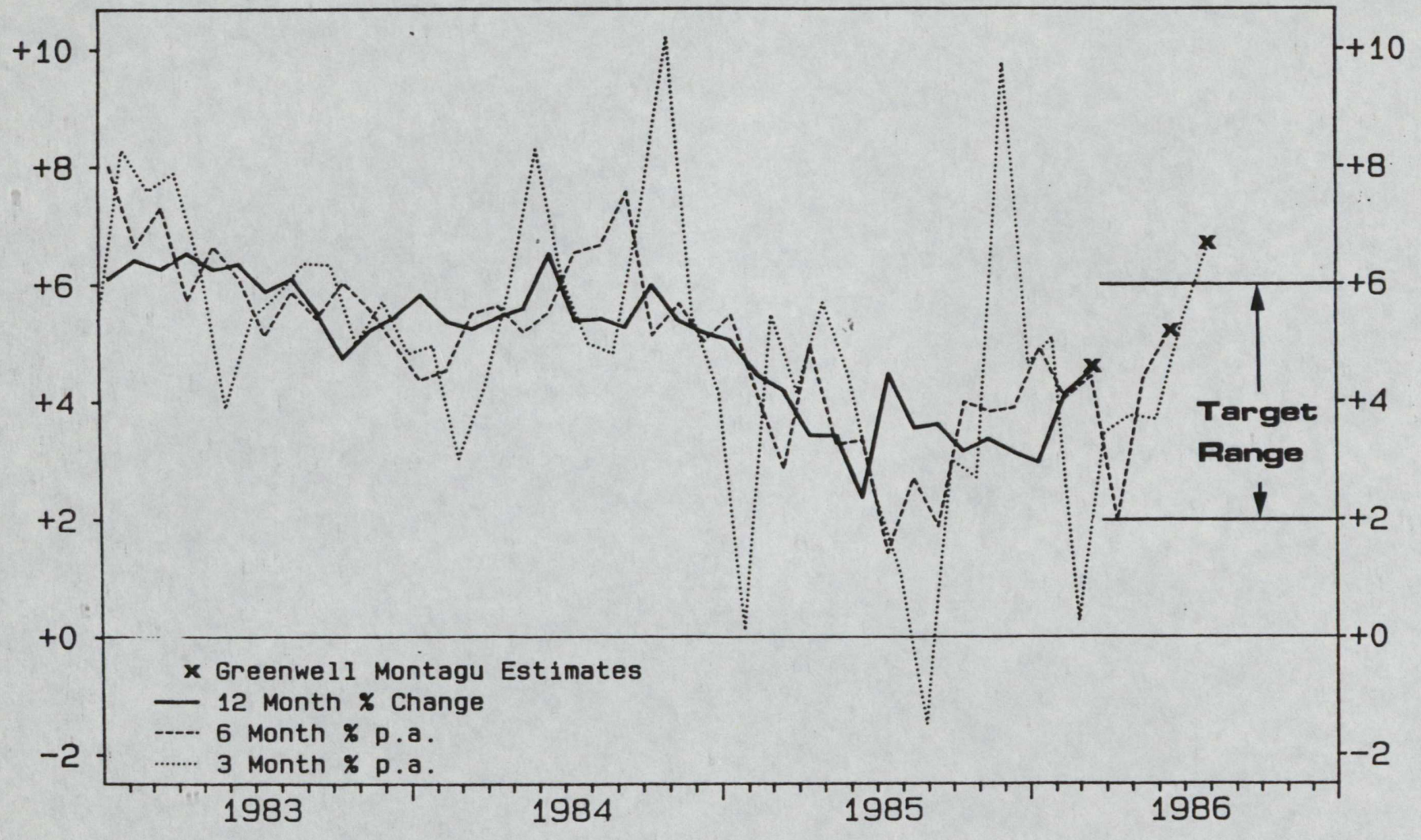
DAVID WILLETTS

Annex A

MONETARY AGGREGATES LOOSENING

	Twelve month growth rates as at: February	August
MO	3.5	4.1
(Non-interest bearing) M1	2.7	7.5
M1	20.2	20.9
M2	9.6	14.1
£M3	14.8	18.5
PSLI	13.8	17.8
PSL2	12.9	14.5

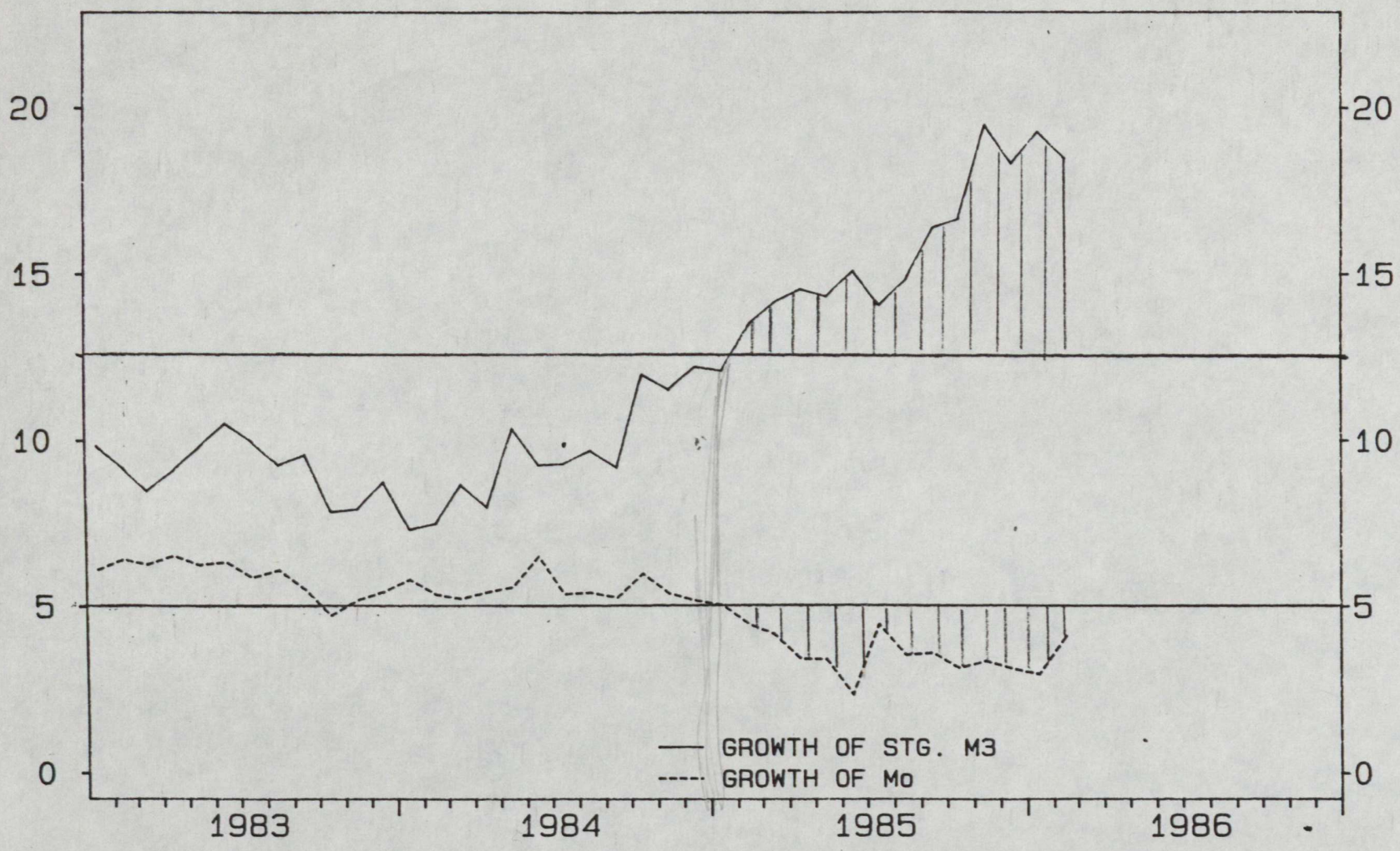
ANNUALISED GROWTH RATES OF M0



Greenwell Montagu & Co.

Annex B

ANNUAL GROWTH OF THE MONEY SUPPLY



Annex C

Greenwell Montagu & Co.

Annex D

FALL IN STERLING NOT CAUSED BY OIL PRICE

	Oil prices	Sterling Exchange Rate Index
	$ per b	1975 = 100
1986		
January	22	76.6
February	16	74.2
March	13	74.6
April	12	76.3
May	14	76.1
June	12	75.9
July	10	74.0
August	14	71.4
September	14 1/2	70.4

67.0

OCTOBER TREASURY ECONOMIC FORECAST - NOTE BY CHIEF ECONOMIC ADVISER

I attach a summary of the latest Treasury economic forecast that will form the published Autumn Statement forecast.

2. The welcome features of the forecast are:

- strong output growth. Non-oil output is expected to grow at 3½ per cent for the next two years;

- growth should be balanced with exports growing at broadly the same rate as domestic demand;

- faster world trade growth;

- some reduction of unemployment;

- continued scope for fiscal adjustment whilst sticking to the MTFS borrowing figures, despite the higher level of public expenditure.

3. The less welcome features are:

- some pick-up of the RPI inflation rate, to $3\frac{3}{4}$ per cent by the end of next year and continued rapid growth of earnings;

- the emergence of a current account deficit on the balance of payments;

- persistent high real rates of interest.

4. In this note I offer my own interpretation of recent indicators and comment on some of the different forecast judgements. This might serve as a useful list of points for discussion.

Output

5. It became clear to us shortly after Easter that output growth this year was turning out below the Budget forecast. It then became clear during the summer the extent to which the pause started earlier in 1985. In the early stages it was disguised by the rebound from the coal dispute.

6. Some slowdown was not surprising. The upturn has lasted much longer than normal. But we took the view that any slowdown was not likely to be severe and it would probably be relatively short-lived. During the summer we argued that we were likely to see a resumption of growth towards the end of this year. The experience with both oil price increases was a lag of about 9 months before anything dramatic happened to output.

7. Outside comment was slow to recognise the pause in output growth and equally slow to recognise the signs that suggested the pause was about to end. Since summer we have had quite clear indications that output growth has resumed.

8. We have to remember that it usually takes a few months before it becomes unambiguously clear that we have passed a turning point. It is often only after revisions to data that the change in the rate of growth is established. But the climate of opinion, which is now mainly concerned with the apparently slow growth of output is now beginning to change and concern with the pause may soon fade.

Domestic Demand

9. An important feature of the forecast is the continued rapid growth of domestic demand. At 3½ per cent a year it matches the

average figure for the rest of the G7. Consumer spending is expected to continue growing rapidly and there is a significant contribution from stockbuilding and private sector investment.

10. The rate of growth of domestic demand shown in the forecast is consistent with a number of indicators:

- the rapid growth of personal sector real disposable income as earnings growth continues to outstrip inflation by a clear margin;

- the high level of real company incomes following the rapid growth of profits;

- the high level of real wealth following the stock market boom, high real interest rates, the low inflation rate and the rise in real house prices.

11. The only potentially depressing factor is the high level of real interest rates. We have always had some difficulty in assessing the effect of persistent high real interest rates on spending and, over time, it may exercise a more powerful impact than assumed in this forecast. There may be more scope for companies to reduce their stock levels but it is difficult to throw doubt on the conclusion that domestic demand is likely to be buoyant next year.

Exports and World Trade

12. The prospect for export demand is more uncertain. The weakness of exports in the latter part of 1985 and earlier this year appears to have been mainly a feature of the world trade forecast rather than poor UK export performance. Indeed in contrast to past trends, since 1981 the UK has maintained its volume share of trade in manufactures.

13. Over the past six months exports have shown resumed growth and it is possible to be more optimistic about world trade. Many

of the reasons for rapid UK domestic demand growth in the UK also apply to other industrialised countries; in some cases with even greater force. This could mean a rapid growth of imports into the industrialised countries with consequential benefits for the exports of the rest of the world. A higher level of exports should provide the basis for some recovery of developing countries' imports - particularly if it is combined with stronger commodity prices although OPEC imports are likely to continue to contract.

14. The biggest risk to the more optimistic prospect for world trade is that many of the developing countries concerned have significant debt problems and may have to make further adjustments to their levels of domestic absorption. In part this explains the rapid reduction of imports in the first part of this year which took us by surprise. But because there has been a rapid initial adjustment of imports the response to higher export earnings may also show up without much delay.

15. If world trade grows faster than expected exports may be higher than shown in the forecast. But I would not place too much weight on this; non-oil exports of goods and services, helped by the lower exchange rate, are already predicted to grow by 5 per cent next year and almost as much the year after.

Inflation and Earnings

16. Inflation for the fourth quarter of next year will be shown in the Autumn Statement as $3\frac{3}{4}$ per cent but it is likely to go above that level at some stage next year, depending upon the path of the mortgage rate. A year or so ago we might have been content with an average inflation rate of under 4 per cent over the three years to 1988 - if the trend was falling. The problem arises because of the very low inflation rate registered this year on the back of falling commodity prices, the collapse of oil prices and falling interest rates. At best we are going to lose the favourable effect of these factors. At worst we may see some reversal of at least some of them.

17. There may be some offset from a lower growth of earnings. The present wage round is beginning at a time of very low inflation and the recent experience of weak manufacturing output growth. The worrying feature is that earnings growth has not fallen in recent years despite high unemployment. In part this can be explained by an absence of pressure upon companies. Initially they had the cushion of large productivity increases and more recently the margin created by falling commodity prices. They have managed to combine increased profits with high pay increases. It may be more difficult to achieve this combination next year and this could be a restraining influence. And there are signs of lower settlements at the beginning of the present round - particularly in manufacturing.

18. The recent exchange rate depreciation may create some further scope for excessive pay settlements. It has eased the constraint upon companies and given them the opportunity to live with higher earnings growth. But they can have no certainty that the lower exchange rate will stick.

19. In the past it has been a mistake to bet on a sharp deceleration of earnings and I would not want to count on it next year either. But there is obviously scope for better performance. The comparison of UK wage costs with those of our international competitors is the most worrying single indicator.

20. Taking these factors together leads me to the view that it will be difficult to do much better next year than the inflation rate shown in the forecast particularly if UK and world demand increase rapidly. But it is important to see this as an inevitable cyclical fluctuation around a longer term downward path. In the longer term that path will be determined by the general stance of monetary and fiscal policies over which the Government has considerable influence.

The Balance of Payments

21. The balance of payments could become an issue again next year after an absence of almost 10 years. I have sent you a separate paper dealing with the underlying analysis of the current account.

22. I am sure I do not need to remind you of the huge margin of error surrounding current account forecasts - witness the scale of the revision since the Budget forecast. Inevitably forecasters are heavily influenced by recent events and relatively small changes to the growth of exports and imports have huge effects upon the current account.

23. The errors can go either way. A faster growth of domestic demand in other industrialised countries would improve the prospect for exports. But it would probably also lead to faster growth of import prices. It is worth recalling that past periods of high world trade growth in the 1960s and 1970s have often coincided with weak UK current account figures because the adverse terms of trade effect more than offset the gain to export volumes.

24. Our trade performance for given UK and world domestic demand might improve relative to past trends. And there is some evidence that recently imports have performed better than we might have expected given the rapid growth of consumption. But it is with the response of imports to final expenditure that most trade forecasts go wrong. The most recent import figures suggest either that domestic demand is growing very rapidly or that imports are now taking a larger share of demand.

Unemployment

25. The unemployment forecasting record is poor. In recent years unemployment has persistently turned out higher than expected mainly because of a very large increase in labour supply. The rise in unemployment earlier this year is not surprising given the slower growth rate through 1985. What was more surprising was that it did not fall earlier when output growth was quite vigorous.

26. The forecast suggests a broadly flat level of unemployment over the next few months followed by some reduction as the growth rate picks up.

27. The September figure became available after completion of the forecast. It is possible that a turning point has arrived earlier than the forecast suggests. It is also possible that we are seeing a bigger than anticipated effect from Restart. But in either case we must now have greater confidence that unemployment will be on a clearly downward trend at some stage over the next year.

Monetary Policy

28. The exchange rate is now about 8 per cent below the profile implicit in the last MTFS and the level of interest rates in line with that profile. During the summer the pattern was the reverse of this with a higher than expected exchange rate and lower than expected interest rates.

29. In the forecast we have maintained interest rates at the present level through next year and assumed a slightly lower exchange rate. The margins of error around this judgement are inevitably enormous. With this combination we expect MO to remain close to the centre of its target range.

30. Money GDP is falling short of the growth rate we expected this year, almost entirely because of export weakness. Next year we expect to see the ground made up.

31. At the moment there is some emerging concern in financial markets that the UK is moving rapidly from a combination of pause, declining inflation and current account surplus to one of rapidly expanding demand, rising inflation and current account deficit. Clearly we have to keep this under review but for the moment we judge that financial policy is broadly on track. We will clearly need to review developments in the context of the Budget, by which time we will have another forecast assessment.

Public Expenditure and Fiscal Policy

32. The forecast shows projected public expenditure figures well above those in last year's White Paper and the MTFS. At Budget time we were aware large revisions were likely. Even so the scale of the revision is even greater than expected; a £4 billion increase in General Government Expenditure next year compared with £1½ billion foreseen at the time of Budget.

33. The revisions compared with the MTFS look stark, but the revenue projections are also revised upwards by even more than expected at Budget time. So some room for fiscal adjustment is still left in 1987-88.

T BURNS
17 October 1986

Overall State

Factors

Instruments for Control

—

M_0 — Interest Rates [Spending / Revenue Deficit]

M_3 — Interest Rates Short term [long-term]

P.M

Exchange Rate — Interest Rates [Tariffs]

Growth of Money — Inflation

Incomes

GDP in Money Terms.

Balance of Payments

T.B

M.T. General Govt Deficit

SECRET 8

C

SHORT-TERM ECONOMIC PROSPECTS

Note by H.M. Treasury

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EA GROUP
17 October 1986

INTRODUCTION

1. This note assesses the prospects for the economy over the next year against the background of recent developments and within the policy framework set out in successive MTFSs. Table 1 summarises recent performance and prospects. In the UK and in other major economies growth has been more sluggish this year than forecast at Budget time, while inflation has been lower. But the prospects for UK growth next year have improved since the Budget.

TABLE 1: SUMMARY OF THE FORECAST

	1984	1985	1986	1987
	(per cent changes on previous year unless stated otherwise)			
Major industrial countries				
Real GNP	4 3/4	3	2½	3
UK				
Nominal GDP	7¼	9½	6	7
Real GDP	2 3/4	3½	2½	3
Real national disposable income	2 3/4	3¼	2¼	3
Domestic demand	2 3/4	2 3/4	3½	3½
Consumers' expenditure	2¼	3½	4½	3 3/4
Exports of goods and services	6 3/4	6¼	1	3
Imports of goods and services	9¼	3	4	4½
Retail price index (per cent change Q4 to Q4)	4 3/4	5½	3¼	3 3/4
Current Balance (£ billion)	1	3½	0	-1½

THE WORLD ECONOMY

2. The UK's recent experience and short-term prospects mirror in many ways those of other major industrial economies. Table 2 sets

[illegible]t recent developments in the world economy and the forecast for 1987. There has been a more marked slowdown in the growth of industrial production than in GNP; and next year this is likely to be reversed with a more pronounced recovery in industrial production.

3. The exports of the major seven countries have been weak in the first half of this year reflecting the fall in demand from OPEC and other developing economies. Non-oil developing countries' imports are unlikely to fall further in 1987 (though some OPEC countries will still be retrenching) and this will remove a negative influence on the growth of developed countries exports.

4. Faster growth in the industrial countries' means that commodity prices are likely to stop falling and rise a little. Indeed, there are tentative signs already that the massive fall in industrial materials prices is coming to an end. Food prices are likely to remain weak. With rising world demand for oil the oil price may remain close to $15 per barrel.

TABLE 2: THE WORLD ECONOMY

	1985	1986	1987
	(Published IMF forecasts in brackets)		
Major industrial countries*			
Real GNP	3.0	2.6 (2.7)	3.1 (3.2)
Industrial production	3.2	1.1	3.9
Exports of goods (volume)	3.8	1.9 (1.6)	3.2 (2.3)
Consumer prices	3.9	1.6 (1.9)	1.8 (2.8)
OPEC and other developing countries			
Imports of goods (volume)	-2.6	-6.7 (-3.6)	0.2 (0.8)
Commodity prices (SDR terms)	-8.9	-7.0	1.1
Export markets for UK manufactures	4½	2	4½

* US, Japan, Germany, France, Italy and Canada.

5. Against this background of a reasonably buoyant world economy the overall growth in the market for UK manufactured exports is likely to rise from 2 per cent in 1986 to 4½ per cent in 1987.

TRADE AND THE BALANCE OF PAYMENTS

Relative costs and prices

6. Costs have been rising faster in the UK than in most other major economies. Nevertheless sterling's depreciation since the second half of 1985 has made possible a marked improvement in manufacturers' competitiveness in spite of these cost trends. The forecast assumes that the exchange rate will be close to the current market level during 1987.

TABLE 3: THE EXCHANGE RATE AND COMPETITIVENESS

		THE STERLING INDEX (1975=100)	RELATIVE UNIT LABOUR COSTS (1975=100)
1984		78.6	118.2
1985		78.2	120.9
1986	(1)	75.1	117.0
	(2)	76.1	116.7
	(3)	71.9	109.1
	(4)	68.5	104.0
1987		67½ (average)	102 (average)

Trade volumes (goods other than oil and erratics)

7. Export volumes fell in the early months of 1986 when world trade growth was sluggish, but have risen again in recent months. Higher growth in world trade, together with the lagged benefits from the lower exchange rate, suggest that export volumes should continue to grow in 1987.

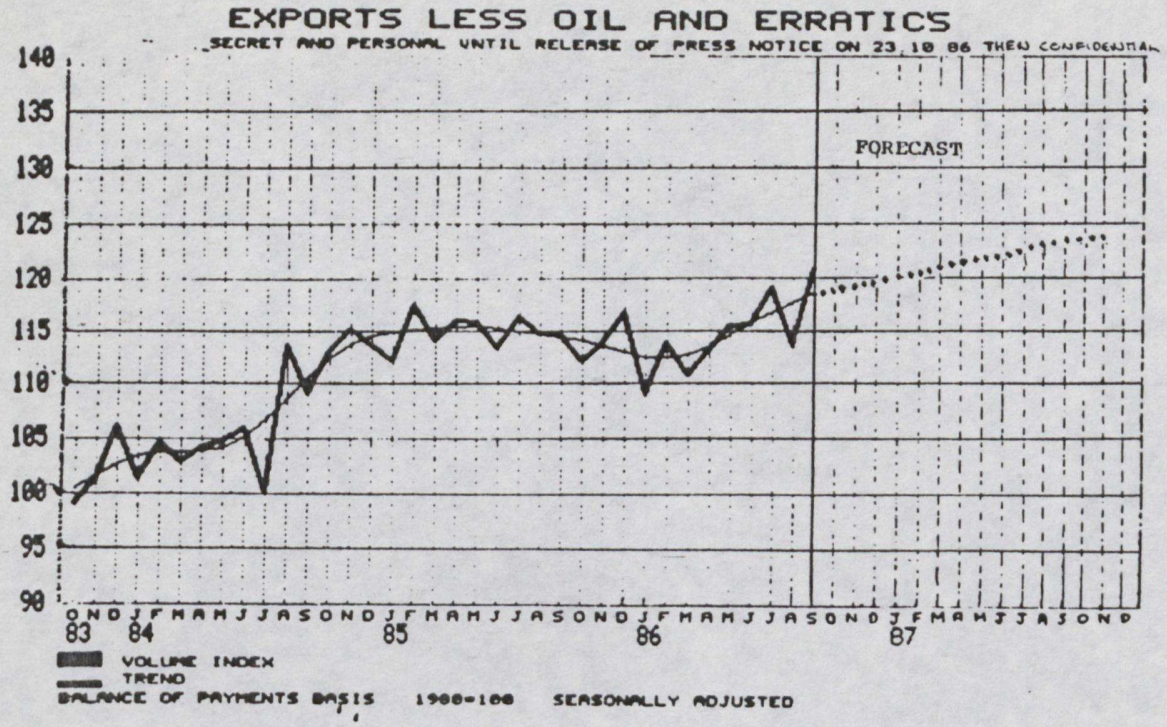


TABLE 4: TRADE IN GOODS

(Per cent changes on previous year)

	Export Volume	Import Volume	Terms of trade* All goods	Non-Oil
1985	5½	3	1½	2
1986	2	4	-6	3½
1987	3	5	0	-1½

* The ratio of UK export average values to import average values.

8. Imports, which grew relatively slowly in the first half of 1986, have tended to rise more rapidly in recent months as domestic demand and activity have strengthened. Imports seem likely to continue to rise relatively strongly in 1987 as domestic activity expands - although the lower exchange rate will tend to slow the rate of growth. The forecast contains a less rapid rise in import volumes than in some previous periods of sharp domestic growth. Over the forecast period the terms of trade may worsen slightly.

Trade in Oil

9. The oil trade surplus is likely to fall by about £4 billion in 1986 compared to 1985 as a result of lower world oil prices. North Sea production is likely to decline gradually in 1987 while at the same time domestic demand for oil may grow modestly in response to both lower prices and rising activity. The oil balance may therefore decline a further £½ billion in 1987.

Invisibles

10. The surplus on invisibles is likely to rise significantly in 1986 as higher earnings from interest, profits and dividends (IPD) more than offset a lower surplus on services. The IPD surplus reflects mainly the effect of sterling's depreciation on the value of overseas earnings. In 1987, a further modest rise in the surplus on invisibles is forecast.

Current Account

TABLE 5: CURRENT ACCOUNT BALANCE
(£ billion)

	Manufactures	Oil	Other Goods	Invisibles	Total	IMF'S forecast of the total current account
1985	-3	8	-7½	5½	3½	
1986	-5½	4	-7	8½	0	1½
1987	-7½	3½	-6½	9	-1½	-1

11. The current account may have moved into deficit in the second half of 1986, following a surplus of almost £1 billion in the first half of year. For the year as a whole the forecast is for broad balance. The fall in the net oil trade surplus coupled with some increase in the deficit on manufactures trade have together more than offset the rise in the surplus on invisibles. The prospect for 1987 is that the current account may remain in deficit at broadly the same rate forecast for the second half of 1986.

DEMAND AND ACTIVITY

12. In the first half of 1986 GDP is estimated to have been around 2 per cent higher than in the first half of 1985; but only about 1¼ per cent higher after excluding the direct effects of the recovery from the coal strike. After adjusting for the coal strike economic growth averaged almost 4 per cent in 1983 and 1984; but slowed down markedly from the beginning of 1985 as exports slowed. Since the fourth quarter of 1985 economic activity has started to rise more quickly again, at an annual rate of about 2½ per cent over the two most recent quarters.

Table 6: REAL GDP AND MANUFACTURING OUTPUT

(Percent changes on a year earlier)

	1984	1985	1986	1987
Domestic demand	3	3	3½	3½
GDP (average measure)	3	3½	2½	3
GDP, adjusted for coal strike	4	3	2	3
GDP, adjusted for coal strike and excluding oil output	4	3	2	3½
Manufacturing output	4	3	0	4

13. Table 6 shows that domestic demand has grown at a relatively high rate in 1986. The fastest growing category of expenditure has been spending by the personal sector. Both consumers' expenditure and housing investment have been growing rapidly. Real personal disposable income has probably grown by some 4 per cent in 1986. With real consumers' spending rising by around 4½ per cent the saving ratio has thus fallen again and is now back to levels last seen in the early 1970s, before the first oil price shock. In 1987 the saving ratio may not change much from its current level and consumers' expenditure may rise by 4 per cent again.

TABLE 7: PERSONAL INCOME AND CONSUMPTION

(per cent changes on a year earlier)

	RPDI	Consumer Spending	Saving Ratio (level)
1984	2½	2	11 3/4
1985	3	3½	11
1986	4	4½	10½
1987	4	4	10½

14. Spending by companies is also expected to be strong in 1987 and domestic demand in total is expected to grow at much the same rate as in 1986, but with faster growth in exports total GDP should grow appreciably faster next year than this.

15. Table 6 shows that growth of the non-oil economy in 1987 may be rather higher than total GDP growth, and we expect a strong recovery in manufacturing output.

Company incomes and expenditure

16. The return earned by non North Sea industrial and commercial companies (ICCs) in 1986 was the highest since 1973 and more than double the return earned in 1981. (See Table 8.) In the first half of 1986 non North Sea ICCs profits net of stock appreciation were some further 17 per cent higher than in the corresponding period of 1985. North Sea companies' profits fell by 54 per cent, however, as a result of the fall in the oil price.

Table 8: REAL RATES OF RETURN FOR NON NORTH SEA ICC's (%)

1973-83	1984	1985	1986	1987
5½	6½	7½	8½	9

17. Table 9 shows recent and forecast investment growth. Company spending has been relatively subdued in 1986. The changes to capital allowances may have caused some capital spending to have been brought forward into 1985 from 1986. North Sea investment has responded quickly to the fall in oil prices.

18. In 1987 non-oil business investment is expected to grow at a rate similar to or slightly faster than this year, reflecting the current favourable level of profitability and the recovery in demand in domestic and foreign markets. A further sharp fall in North Sea investment is likely.

Table 9: FIXED INVESTMENT

(Per cent growth on previous year)

	1985	1986	1987
Business	4	1	2
(o/w manufacturing	6	1	5
oil	-7	-16	-13
other	7	4	4
Residential	-1	3	6
General Government	-4	4	-2
Total	2	2	2

19. Companies' expenditure on stocks has been running at a low level this year. The 1984 Budget corporate tax changes will have been an influence but stock ratios have been falling since 1980. Although surveys do not suggest that stocks have yet reached desired levels in relation to output or sales we expect higher stockbuilding next year.

COSTS AND PRICES

20. Between the spring of 1985 and August this year the prices of materials and fuels purchased by manufacturing industry fell almost continuously. The recent fall of sterling and a modest recovery in some world primary commodity prices mean that this decline in industry's input costs is probably over. Import prices have also been falling. But in spite of the fall in price inflation, there has been no decline in the underlying rate of growth in average earnings. The underlying growth of real pre-tax earnings has been above 4 per cent in 1986. Unit labour costs in both the non-oil economy as a whole and manufacturing will probably have risen by close to 6 per cent during 1986.

21. As RPI inflation is 3 percentage points lower than it was at the start of the last pay round, pay settlements in the current round are expected to be lower than last year. Despite an increase in overtime working the growth of average earnings is expected to fall a little in the present pay round. Table 10 shows some estimates of costs in manufacturing industry, the sector for which there is most information.

Table 10: COSTS IN MANUFACTURING

(Per cent changes on a year earlier)

	Average earnings	Unit labour costs	Cost of Materials and fuel*	Estimated total costs**	Output prices
1984	8½	2½	8½	5	5½
1985	9	5	4	4½	6½
1986	8	5½	-11½	½	4
1987	7½	2½	2½	3½	3½

* Producer prices excluding food, drink and tobacco.
** Including costs of bought-in services

22. The RPI rose by 3 per cent in the year to September 1986, compared with a rise of 5½ per cent in the year to 1985 Q4. Falls in mortgage interest rates earlier in the year have contributed to reducing the growth in the RPI: retail prices excluding mortgage costs have risen by about 3¼ per cent over the last year.

23. The increase in the RPI excluding mortgage interest costs over the next year is not likely to be very different from what it has been over the past year. However the effect of mortgage interest costs on the all items RPI is likely to be less favourable next year. The forecast increase of a 1¼ percentage rise in the mortgage rate in the fourth quarter of 1986 adds about ½ a point to RPI inflation for most of 1987.

Table 11: RETAIL PRICES INDEX

(Per cent changes on a year earlier)

	Weight in the RPI	1984Q4	1985Q4	Forecasts 1986Q4	1987Q4
Food	18½	3¼	3	3¼(3)	2½
Nationalised industries	7	4¼	5½	3 (4)	1½
Housing	14	10½	9½	5½(7½)	11½
Other	60½	4	5½	2 (3)	3
Total RPI	100	4 3/4	5½	3¼(3½)	3 3/4
Total RPI less mortgage interest costs		4	5¼	3¼	3¼

* FSBR forecast in brackets

PRODUCTIVITY AND THE LABOUR MARKET

24. Over the last year growth in employment has slowed down, reflecting the slower growth of output. In the year to June 1986, the employed labour force grew by around 200,000 (see Table 12). Employment growth in the service industries remains very strong: the number of employees in the service industries increased by some 250,000 in the year to June 1986. However, the number of employees in manufacturing industries fell by 90,000 while almost 50,000 jobs were lost in the energy extraction and water supply industries. Employment is forecast to grow by 1 to 1½ per cent next year, with perhaps half a million new jobs created between the middle of 1986 and the end of 1987.

TABLE 12: EMPLOYMENT

(Thousands, change in GB, seasonally adjusted)

	Employees in employment*			Self employed	HM Forces	Total Employed labour force
	Male	Female full-time	Female part-time			
June 1983 to June 1984	- 37	+ 5	+ 221	+ 275	+ 4	+ 467
June 1984 to June 1985	+ 46	+ 3	+ 174	+ 108	0	+ 332
June 1985 to June 1986	- 59	- 30	+ 172	+ 122	- 4	+ 200

* Figures for employees are subject to revision when results from the 1984 Census of employment become available (possibly in December)

25. Productivity growth has fallen back during the last year, as is normal during a period output growth is below trend. Faster output growth in 1987 should mean some pick-up in growth in recorded productivity in the non oil economy, although the expected fall in North Sea output will tend to depress growth in productivity for the economy as a whole. Table 13 shows estimates of trends in productivity.

TABLE 13: TRENDS IN PRODUCTIVITY

(per cent change in output per head, adjusted for the effects of cyclical fluctuations in output)

	Manufacturing	Whole economy	Non-oil economy
1979-85	3	1¼	1½
1985-88 Forecast	2½	1 3/4-2	1¼-1½

Unemployment

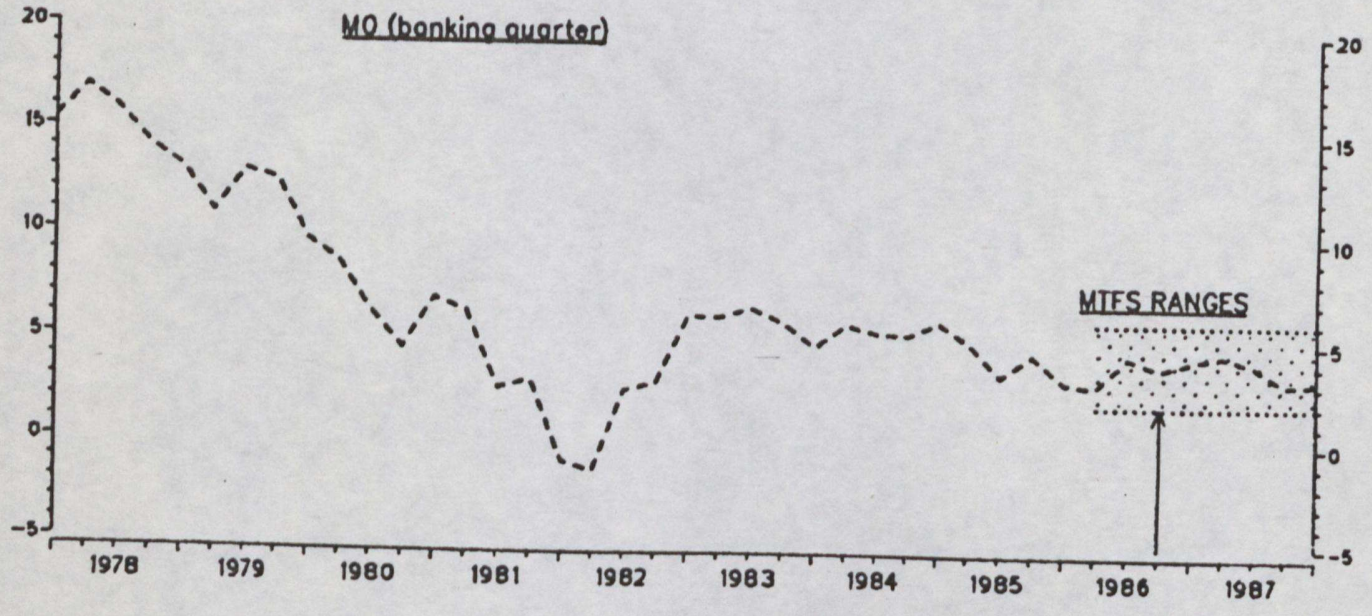
26. As employment growth picks up next year, unemployment is expected to fall. Although non-oil output growth, at 3½ per cent next year, is not as fast as it was between mid 1983 and mid 1985, we do not expect the very large increase in labour supply which kept unemployment rising during the earlier period to recur.

27. The forecast has unemployment broadly flat over the next few months, but the September unemployment figure became available after completion of the forecast. The substantial fall shown in September (and the fall now shown in the revised figure for August) suggest that the initial impact of Restart may have been greater than assumed in the forecast; and the trend excluding Restart may also currently be more favourable.

FINANCIAL CONDITIONS

28. The growth of MO has risen to 4 per cent - slightly above the mid-point of its target range - over the last few months, mainly as a response to earlier interest rate cuts and strong growth in personal disposable income. Following the recent rise in interest rates MO is expected to grow more slowly.

M0: % CHANGE ON YEAR EARLIER



29. £M3 has continued to outstrip the target range set in the 1986 MTFS, with growth in excess of 18 per cent in the year to September. This has reflected at least partly the increased attractiveness of interest-bearing bank deposits relative to other financial assets: the wider measure of broad money, PSL2, has risen by 14 per cent.

30. During the past year we have had another sharp fall in the velocity of £M3. For the past six years fast rates of growth of broad money - largely the result of financial innovation and liberalisation - have been consistent with a substantial fall in inflation and, for almost all of this time, with appropriately tight monetary conditions.

Interest Rates

31. Market short term interest rates which fell by more than 2 percentage points after the Budget have risen by about 1 percentage point since the end of August. This recent rise in interest rates, which will of course be followed by a corresponding rise in mortgage rates, reflected a response to somewhat looser monetary conditions as indicated by a slightly faster rise in MO and the relative weakness of sterling.

32. The forecast assumes that market short-term interest rates - and therefore base rates and the mortgage rate - stay at the new high levels throughout 1987.

FISCAL DEVELOPMENTS

33. Table 14 shows the latest projections of government expenditure, revenue and borrowing in 1986-87 and 1987-88. The figures for expenditure are close to our best guess at the outcome of the current round of ministerial discussions.

TABLE 14: PUBLIC SECTOR BORROWING

(£ billion)

Implied planning total?

	1985-86	1986-87	1987-88
General government expenditure (GGE)	159	165	173½
General government receipts	152	156½	168
Fiscal adjustment	-	-	2
General government Borrowing Requirement	7	8½	7½
Public corporations market and overseas borrowing	-1	-1	-½
Public Sector Borrowing Requirement	6	7½	7
(as percentage of GDP)	(1½)	(2)	(1 3/4)
GGE as percentage of GDP			
Including privatisation proceeds	44	43½	42½
Excluding privatisation proceeds	44 3/4	44 3/4	43½

34. The PSBR in 1985-86 was £5.6 billion, around £1 billion lower than forecast in the FSBR. In the first six months of 1986-87, the PSBR was £6 billion. General government expenditure in 1986-87 is now likely to be £1½ billion higher than expected at the time of the FSBR, but the forecast of receipts is £½ billion higher, with lower oil revenues more than offset by increases in non-North Sea tax revenues and other receipts. Public corporations market and overseas borrowing (PCMOB) is now projected to be £½ billion lower than the FSBR forecast. The total PSBR for the year as a whole is now projected at £7½ billion, an increase on the Budget time forecast approaching £½ billion. There is still a substantial margin of error surrounding this forecast. At this stage of the year, the average error on PSBR forecasts has been 3/4 per cent of GDP (equivalent to £3 billion).

35. In 1987-88 the PSBR is assumed to be kept to 1 3/4 per cent of money GDP, as in the 1986 MTFS, by means of a fiscal adjustment. Since the Budget the forecasts of both general government expenditure and receipts have been revised up by some £3-4 billion, leaving the fiscal adjustment around £2 billion, much as anticipated at Budget time. The share of general government expenditure in money GDP is likely to fall in the current financial year if privatisation proceeds are included in public expenditure, though not if they are excluded. (We showed both measures in the Autumn Statement last year). On either measure there are falls in 1987-88.

E.A.
17 October 1986

D

The final chart at the back of this is interesting.
DCW

THE CURRENT ACCOUNT

Background

The current account measures the overall balance of current transactions with the rest of the world. It indicates the extent to which the UK is acquiring new assets overseas (a surplus) or running them down (a deficit). The main constituents are trade in goods and services, income on the assets we hold overseas net of the income on foreign owned assets in the UK, and transfers between the UK and other countries.

2. On average over the last 30 years the UK has been close to balance. The traditional pattern has been surpluses on trade in manufactures and services, together with a net flow of income from abroad, offset by deficits on fuel and other goods, especially agriculture and materials. Of course this pattern has been changing over time. For many years our surplus in manufactures has been declining, while the surplus on services has been increasing and the deficit on basic materials and agriculture falling.

3. After 1979, however, the pattern changed sharply, with the build up of North Sea oil production leading to a surplus on our fuel trade. Inevitably this has been accompanied by some deterioration in the other elements of our external account, but over these past 7 years we have nevertheless run overall surpluses averaging 1-1½ per cent of GDP. Our overseas assets, and the income they yield, have been building up steadily. By the end of last year the stock of net assets had risen to £80 billion or a quarter of our GDP, and by the end of this year that figure is likely to have risen to over £100 billion.

The prospect

4. Most commentators now believe that the UK current account is about to move into deficit. Indeed there has been a significant deterioration this year already, from a surplus of £3½ billion in 1985 to close to balance this year. But in present circumstances a move into deficit is not at all surprising.

5. The collapse of oil prices earlier this year has had a profound effect on the world economy and in particular on the UK. For us it means an immediate drop in our export earnings from oil and thus a deterioration in the current account position. At the same time, North Sea production is gradually starting to decline. The combined effect is to cut sharply the value of our surplus on oil trade - even after allowing for a reduced flow of North Sea profits abroad - by about £2½ billion between 1985 and 1987.

6. Since the oil price fell at the beginning of the year sterling has fallen by about 15 per cent. Eventually that will benefit our non-oil trade, reversing some of the deterioration since 1979. But the process of adjustment, though necessary, inevitably takes time. New markets have to be found and exploited, and resources shifted from domestic production into exports and import substitutes.

7. Moreover the main effect in the short run of the fall in the exchange rate is to make our imports more expensive and to reduce the foreign exchange value of our exports. Changes in import and export volumes take longer to come through. So for a while the current account gets worse, and this has almost certainly been one factor underlying the recent deterioration. This is frequently known as the 'J-curve effect'. Much the same has happened in the United States, where a falling dollar has been accompanied in recent months by a further widening of their trade deficit.

8. The oil price collapse also affects us indirectly, through its effect on other countries. Oil exporting countries have been hit hardest and have reacted quickest. Their imports have been cut back, adversely affecting important markets for our exports. Oil importers, including most of the European Community, have been slower to respond to the opportunities provided by lower energy prices and their non-oil imports are rising faster. So far the net effect has been a deterioration in our export markets though in time this ground should be made good - indeed, we are already beginning to see the first signs of that.

9. Another important factor underlying our current account position is the growth of domestic demand. In recent years the gap between domestic demand growth in the UK and the other major industrialised countries has been reduced and over the past three years virtually eliminated. A major cause of this has been the persistently high level of UK wage settlements, coupled with some decline in the savings ratio. The net result has been a faster growth of imports relative to that of exports.

Assessment of the Present Position and Prospect

10. The scale of current account deficit which we and other informed commentators are expecting in 1987 is relatively small. A deficit of £1½ billion would be about one half per cent of GDP. This is small in relation not only to the surpluses of recent years but also to the deficits experienced in the early 1970s. It is very small in relation to the imbalances in the payments positions of the US, Japan and Germany, which currently stand in the range 3-4 per cent of GDP.

11. Some deterioration in our current account balance is inevitable in the short run as a result of the oil price collapse, and a small deficit is not at all a reason for alarm. We cannot run surpluses every year. And it is impossible for all countries to run surpluses; surpluses in some countries have to be offset by deficits elsewhere.

12. We start from a strong position. Our strategy in the period of high oil revenues has been to invest a high proportion of them overseas. In the last six years our net stock of overseas assets has risen by an average of 4 percentage points of GDP per year, and the total stock now stands at over a quarter of GDP. This will yield income for the future which will strengthen the current account and cushion the effects of declining oil production. Our overseas income has been building up over recent years, and with the recent fall in sterling we expect a continuing rise in income from this source in the next few years.

13. Nevertheless, the decline in our oil surplus means that an improvement in our non-oil trade is necessary. As the Chancellor explained in a speech at Cambridge three years ago a lower real exchange rate would be part of the mechanism that would lead to the necessary improvement. There has been a major adjustment to the nominal exchange rate which in time will have beneficial effects on the non-oil balance provided that it is not offset by high inflation. In addition some improvement should occur anyway as the temporary adverse factors fade away: in particular the relative weakness of our export markets, and the adverse impact of the fall in the exchange rate before resources are shifted into exports and import substitution.

14. The main worry is that this shift of resources will not take place if the familiar long-term problems of excessive pay settlements and inadequate non-price competitiveness reassert themselves. The pay situation is worrying, and must be improved. But there have been some signs that our underlying trade performance has been improving in recent years. The decline in our share of world trade observed for many years has slowed or even stopped altogether, and the growth of import penetration has slowed down. It is important that this improving trend continues if we are to avoid a continuing weakness in our external position in the medium term.

15. These developments are well understood in the financial markets, and the prospect of a deficit on the current account next year has almost certainly been discounted in the present exchange rate. It is of course still possible that the emergence of a deficit next year may unsettle the markets, but this is unlikely to be serious unless the prospect for oil prices and the current account deteriorate further. The exchange rate is now much less influenced by the current account than it used to be and much more by the capital account: financial flows across the exchanges are estimated to exceed trade flows by a factor of at least 5, so it is the maintenance of market confidence in economic policy that is of paramount concern.

Implications for Policy

16. The world is very different from that of the 1950s and 1960s when we suffered from recurring balance of payments problems. Given our commitment to anti-inflationary policies, our exposure to exchange rate crises is much reduced, provided that financial markets recognise this commitment. There is no need to contemplate the kind of sharp tightening of policy which was necessary in earlier periods when the current account moved into deficit. It is, of course, important to let the exchange rate adjust, and that has already happened. Our estimates suggest that the real exchange rate has probably fallen enough to offset fully, in the long run, the adverse effects on the current account of the fall in oil prices. We shall continue to take account of the exchange rate in operating our monetary policy, and it would be right in present circumstances to err on the side of caution.

17. There is certainly no case for continuous depreciation of sterling to speed up the process of adjustment. That is the route to higher inflation, and as a means of improving the current account quickly it would be largely self defeating. Continuous depreciation would exacerbate the short term problems we are facing, by steadily increasing the cost of our imports and reducing the value of our exports before the necessary shifts of resources into net exports could reasonably be expected to occur.

18. The main emphasis of our policy must be to maintain a firm anti-inflationary stance, and we must also be on our guard against any excessive growth of domestic demand. That will contribute to the maintenance of confidence in the financial markets and in sterling, and help ensure that the benefits of the decline in sterling which has already occurred will not be frittered away in higher UK costs. A prudent approach to policy along these lines, including a cautious approach to setting interest rates, should ensure that the current account deficit we expect can be financed by capital inflows on the required scale.

19. There is no case for employing protectionist measures to improve trade flows directly. In principle it would be possible to discriminate against foreign goods, either by subsidies to domestic industry or by using foreign exchange premia* and other discriminatory devices in our public purchasing policies. But we have we have everything to gain from free trade, and everything to lose from a move to protectionism. What is required is a permanent shift of resources into exports and import substitutes so as to produce a competitive and sustainable structure for the economy.

20. Protective devices are costly and inefficient, and thus reduce our output and real incomes. This applies not just to direct restrictions on imports but also to export subsidies, to foreign exchange premia, and to other attempts to bias our public purchasing policies so as to "buy British" where that is not the most cost-effective choice. That is why we abolished the use of foreign exchange premia in 1979. And discrimatory public purchasing policies would fall foul of our international obligations: both the Treaty of Rome and the GATT require that contracts covering the bulk of government purchasing (with military equipment the main exception) shall be open to competitive tendering. There is nothing in the current or prospective balance of payments situation that would justify a reversal of the Government's policies of minimal intervention in the direction of trade.

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*A foreign exchange premium is a device which is used to distort public purchasing decisions or cost-benefit analyses by assuming an additional cost from any use of foreign exchange.

ANNEX: HISTORICAL DATA

Tables

1. The UK current account

2. Current account balances in the major economies

Charts

1. UK current balance as a percent of GDP

2. UK share of world trade in manufactures

3. Share of UK imports of goods (excl oil) in total final expenditure

4. Net overseas assets as a percent of GNP

TABLE 1: UK CURRENT ACCOUNT

	Fuel+								
	Total	Oil+	Manufactures	Other Goods	Services	IPD+	Transfers	Current Account	% of GDP (£ billion in brackets) Outside Forecasts
1955-59	-1.3	n/a	+7.9	-6.9	+0.2	+1.1	-0.3	+0.7	
1960-64	-1.2	n/a	+6.2	-5.9	0.0	+1.1	-0.4	-0.2	
1965-69	-1.1	n/a	+4.9	-4.7	+0.3	+1.0	-0.5	0.0	
1970-74	-1.7	-1.7	+3.6	-4.0	+1.0	+1.3	-0.4	-0.3	
1975-79	-2.2	-2.2	+3.2	-3.3	+1.8	+0.9	-0.8	-0.4	
1980-84	+0.3	+0.6	+0.6	-1.6	+1.3	+1.5	-0.8	+1.3	
1985*	+0.8 (+3.0)	+1.3 (+4.5)	-0.9 (-3.0)	-1.6 (-5.7)	+1.6 (+5.8)	+2.0 (+7.0)	-1.0 (-3.5)	+1.0 (+3.6)	
1986	+0.4 (+1.4)	+0.7 (+2.7)	-1.4 (-5.4)	-1.6 (-6.0)	+1.4 (+5.3)	+1.9 (+7.1)	-0.7 (-2.4)	0.0 (0.0)	+0.2 (+0.8)
1987	+0.1 (+0.6)	+0.5 (+1.9)	-1.8 (-7.3)	-1.3 (-5.3)	+1.3 (+5.2)	+2.1 (+8.5)	-0.8 (-3.2)	-0.4 (-1.5)	-0.6 (-2.3)

+Contribution of North Sea oil defined as visible surplus less North Sea profits due abroad. The latter is therefore excluded from IPD.

*Coal strike reduced current balance in 1985 by £1½ billion (0.4% of GDP).

Table 2

Current account Balance as Percentage of GNP

	1960-85	1960-65	1966-70	1971-75	1976-80	1981-85
US	0.0	0.9	0.2	0.2	-0.2	-1.5
Japan	0.7	-0.1	0.8	0.7	0.4	1.9
Germany	1.2	2.3	1.7	1.1	0.7	0.7
Canada	-0.6	0.1	-0.6	-0.7	-1.7	-0.1
UK	0.1	-0.2	0.3	-0.9	0.1	1.2
France	0.0	0.8	-0.4	0.0	0.1	-1.1
Italy	-0.1	-1.0	2.5	-0.7	0.2	-1.2
Belgium	0.2	0.4	0.9	2.1	-1.6	-0.8
Netherlands	0.5	-2.2	-0.5	2.3	-0.1	3.2
Denmark	-3.1	-3.6	-2.8	-1.8	-3.9	-3.5
Finland	-1.4	-0.5	-0.9	-3.7	-1.1	-1.1
Norway	-3.7	-9.6	-1.5	-4.0	-6.4	4.2
Sweden	-0.6	0.1	-0.4	0.7	-2.2	-1.5
Switzerland	0.4	-5.1	0.9	1.2	3.0	3.1
Spain	-1.6	-2.9	-2.1	-0.6	-1.3	-0.8
Australia	-3.0	-2.9	-3.3	-1.0	-2.9	-4.8
New Zealand	-3.4	-1.4	-2.0	-4.1	-4.1	-5.9
Ireland	-7.1	-10.0	-3.1	-4.4	-8.4	-8.8
Austria	-1.6	-2.5	-1.5	-0.7	-2.5	-0.5

Chart 1: UK Current Balance as a % of GDP

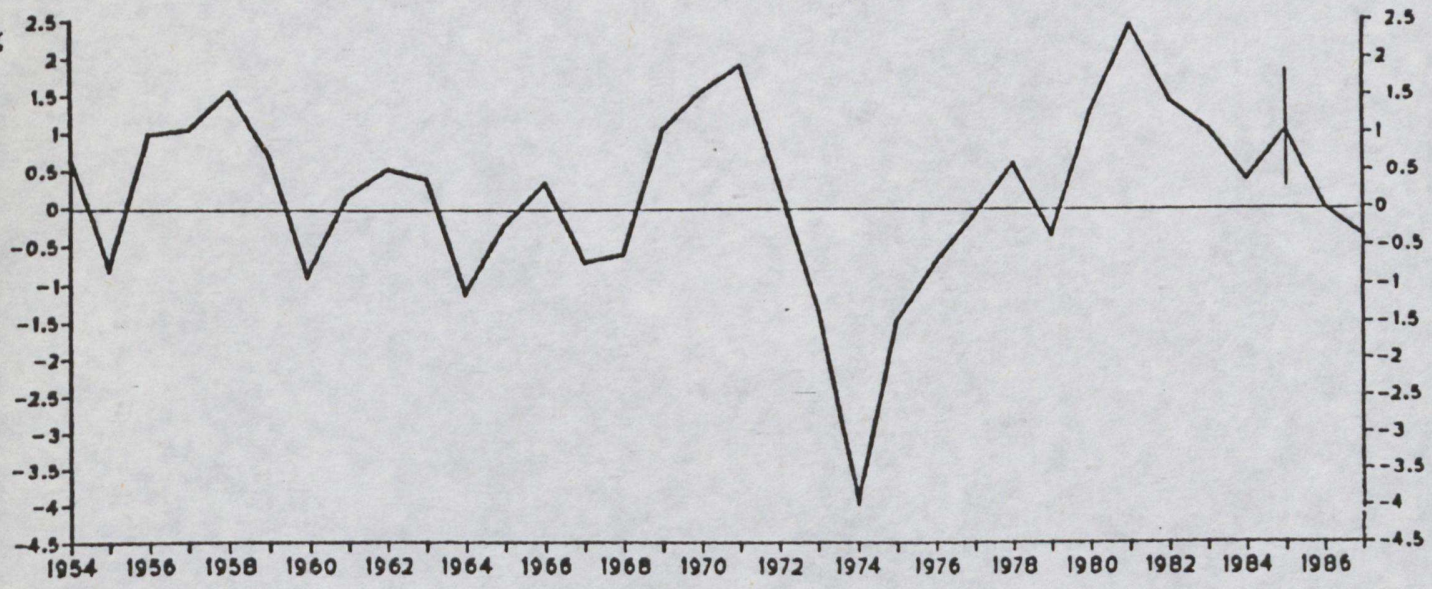


Chart 2: UK share of World Trade in Manufactures

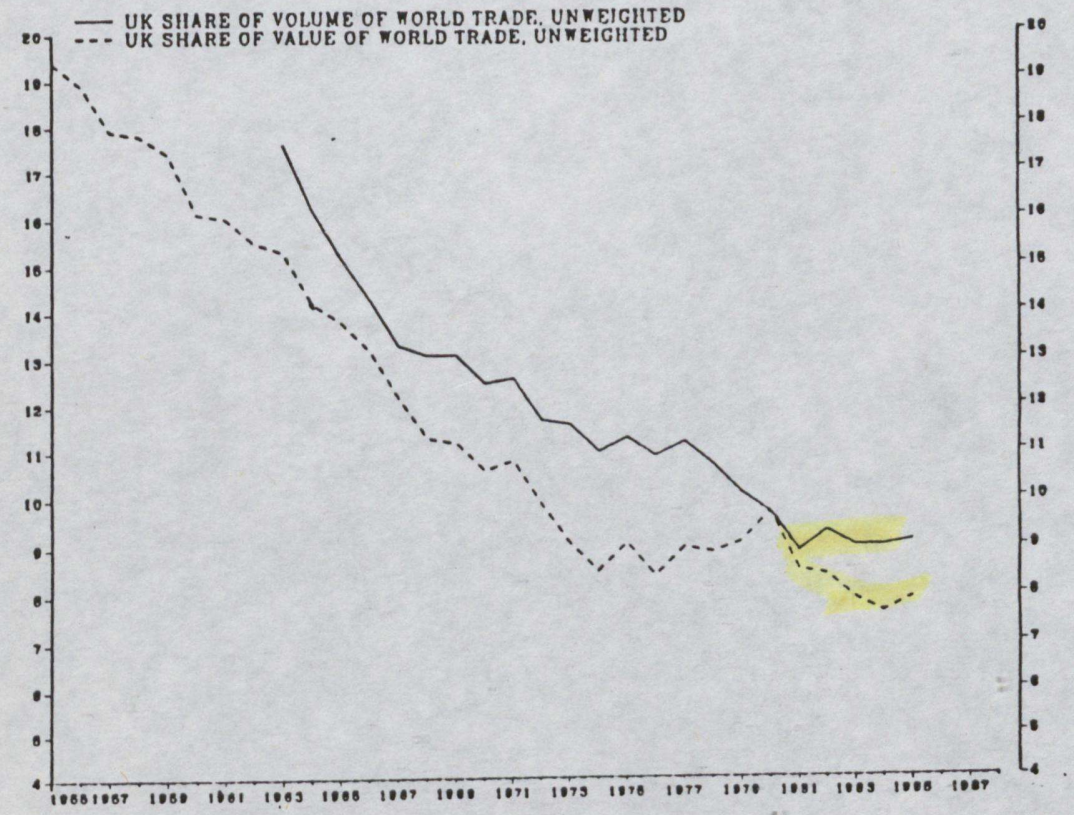


Chart 3: Share of UK imports of goods (excl. oil) in total final expenditure

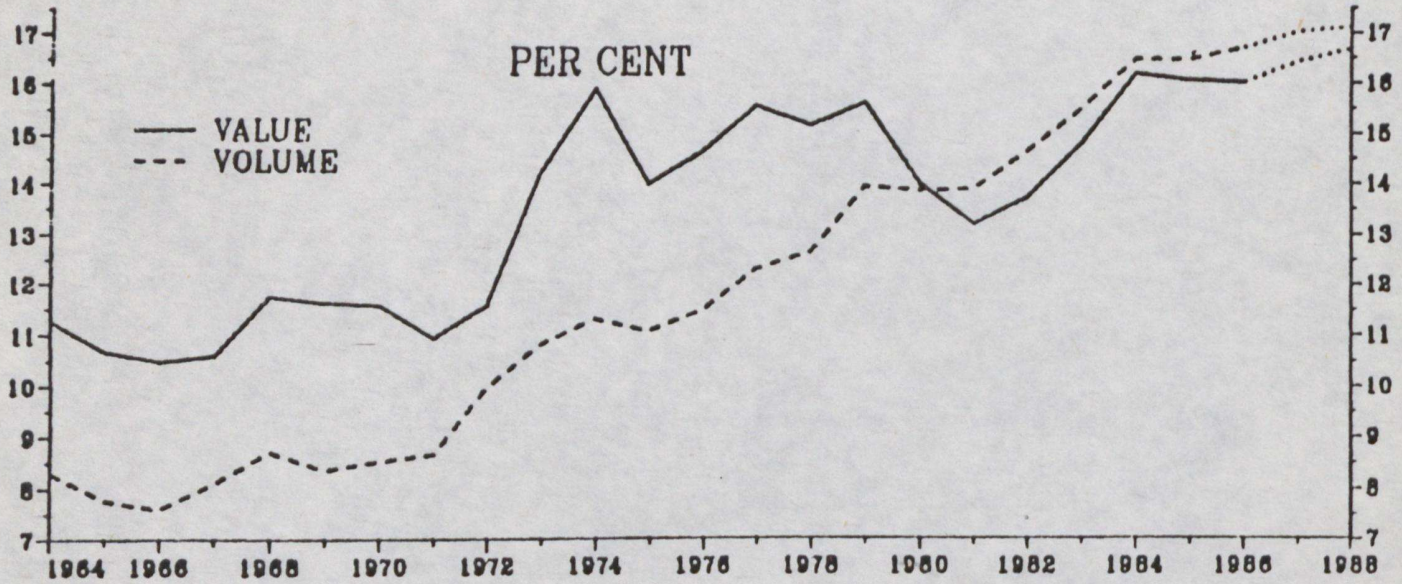
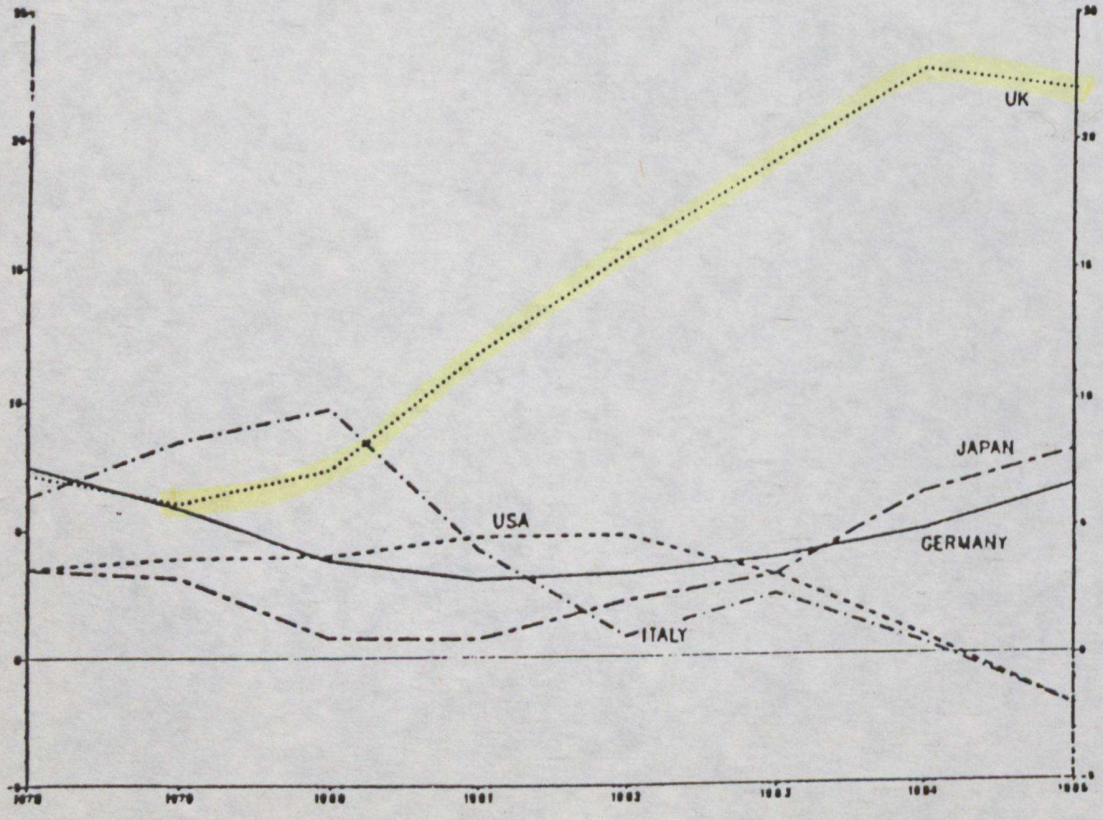


Chart 4: Net overseas assets as a percent of GNP



DATA SOURCES: NATIONAL DATA AND DEFINITIONS QUOTED IN THE FIFTY SIXTH ANNUAL REPORT OF THE BANK FOR INTERNATIONAL SETTLEMENTS, BASEL 8 JUNE 1986 (NET ASSETS) AND INTERNATIONAL FINANCIAL STATISTICS (GNP)