MR 1/41

SECRET AND PERSONAL 7

Treasury Chambers, Parliament Street, SW1P 3AG
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17 October 1986

David Norgrove Esq
10 Downing Street
London SW1

Dear David

TREASURY ECONOMIC FORECAST

I am sending you separately the papers for discussion at the seminar at Chequers on Sunday. Attached to this note is the internal forecast report prepared by the Treasury economists.

As you know, this report from the forecasters forms the basis for discussion between Ministers, officials and the forecasters. These discussions take on board past experience of the margins of error and consider what numbers should be published as the Government's own forecast.

The numbers in the papers prepared for Chequers are therefore slightly different from the numbers in the report below. The numbers in those papers are agreed to be realistic forecasts for publication.

Yours
Alex

A C S ALLAN
Principal Private Secretary

SECRET

COPY NO. 14

TREASURY ECONOMIC FORECAST

OCTOBER 1986 REPORT

Contents **Page**

A	Summary of results and discussion of main issues	2
B	The World Economy	12
C	Public Finances	17
D	Interest rates, the exchange rate, competitiveness, and financial conditions	22
E	Oil production, investment, trade, and government revenues	27
F	Non-oil trade	29
G	Inflation	38
H	Personal and company income and expenditure	45
I	Productivity, employment and unemployment	51
J	Aggregate demand and activity	55

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TREASURY ECONOMIC FORECAST

REPORT BY EA

INTRODUCTION

This report summarises the results of the internal Treasury forecasting exercise carried out during the last month. The report covers world economic prospects, public finances, and the North Sea, hitherto almost entirely discussed in separate documents. Most copy recipients of this report will receive copies of the detailed reports on

World Economic Prospects (Mr Matthews, EF2),

Public Finances (Mr Mowl, PSF),

and a short summary of

The Financial Forecast (Mr. Mowl).

In addition to the more detailed descriptions than are in this report are available on request of the forecasts of

The Balance of Payments

and **North Sea production, investment, prices and revenues.**

2. The forecast covers the period to the end of financial year 1988-89. It therefore covers two of the three years for which the Autumn Statement will give plans for public expenditure and which the 1987 MTFS will cover.

A SUMMARY OF RESULTS AND DISCUSSION OF MAIN ISSUES

(a) Assumptions

3. The forecast assumes that the overall stance of policy is broadly as adumbrated in successive versions of the MTFS.

- It is assumed that **interest rates** vary to achieve money conditions broadly consistent with the achievement of the MTFS path for money GDP.

TABLE A1 : SUMMARY OF THE FORECAST

		MARCH 1986 FSBR/MTFS	JUNE 1986 FORECAST	**OCTOBER 1986 FORECAST**	OCTOBER 1986 AVERAGE OUTSIDE FORECAST
1.	**World GNP (major 7)** (Per cent change on year earlier				
	1985	2.7	2.8	**2.8**	
	1986	3.4	2.8	**2.6**	
	1987	3.6	3.6	**3.1**	
	1988	3.2		**3.0**	
2.	**Effective Exchange Rate (1975=100)**				
	1985	78.2	78.2	**78.2**	-
	1986	73.7	75.2	**72.9**	71.5
	1987	71.5	71.7	**67.2**	68.5
	1988	69.2		**65.2**	-
3.	**Nominal GDP (market prices)** per cent change on year earlier)				
	1985-86	9.6	9.7	**9.6**	
	1986-87	6.8	5.8	**5.5**	
	1987-88	6.4	7.0	**7.3**	
	1988-89	6.3		**8.0**	
4.	**GDP Volume** (per cent change on year earlier)				
	1985	3.3	3.3	**3.6**	-
	1986	3.1	2.4	**2.3**	2.4
	1987	2.4	3.1	**2.9**	2.6
	1988	2.7		**3.0**	-
5.	**RPI** (per cent change on year earlier)				
	1985 Q4	5.5	5.5	**5.5**	-
	1986 Q4	3.6	2.3	**2.8**	2.9
	1987 Q4	3.3	4.0	**4.1**	4.5
	1988 Q4	3.2		**5.0**	-
6.	**Unemployment** (UK s.a. excluding school leavers, millions)				
	1985 Q4	3.18	3.12	**3.12**	-
	1986 Q4	3.13	3.26	**3.23**	3.19
	1987 Q4	3.07	3.14	**3.15**	3.14
7.	**Current Balance** (£ billion)				
	1985	3.0	3.8	**3.6**	-
	1986	3.6	2.9	**0.3**	1.2
	1987	2.6	-1.4	**-1.8**	-1.9
	1988	4.0		**-3.4**	-

TABLE A1 (contd.)

		MARCH 1986 FSBR/MTFS	JUNE 1986 FORECAST	OCTOBER 1986 FORECAST	OCTOBER 1986 AVERAGE OUTSIDE FORECAST
8.	**PSBR - £ billion** (per cent of GDP in brackets)				
	1985-86	6.8(1.9)	5.9(1.6)	5.8(1.6)	-
	1986-87	7.1(1.9)	7.5(2.0)	8.4(2.2)	8.0
	1987-88	7.1(1.7)	7.1(1.7)	7.1(1.7)	9.8
	1988-89	6.8(1.6)		7.0(1.6)	-
9.	**Fiscal Adjustment (annual not cumulative** (£ billion)				
	1987-88	2.5	2.2	2.4	2.3
	1988-89	4.0	5.8	5.6	-
10.	**Interest Rates (Short-term** (per cent)				
	1986 Q4	11.0	9.0	11.0	9.6
	1987 Q4	9.5	9.5	11.0	8.9
	1988 Q4	8.4		11.0	-
11.	**Money Supply MO** (per cent change)				
	1985-86	4.4	4.4	4.4	-
	1986-87	2.6	4.0	3.8	5.5
	1987-88	3.9	5.1	3.9	5.5
	1988-89	4.9		3.5	-
12.	**RNDI (percentage change on a year earlier)**				
	1985	2.9	3.0	3.3	
	1986	3.5	2.6	2.3	
	1987	2.2	2.8	3.0	
	1988	2.9		3.0	
13.	**Volume of Domestic Demand** (percentage change)				
	1985	2.4	2.2	2.8	-
	1986	3.4	3.3	3.4	-
	1987	2.5	4.1	3.6	-
	1988	2.6		3.5	-
14.	**Volume of Exports of Goods and Services** (percentage change excluding fuel in brackets)				
	1985	6.0	6.3	6.2(6.2)	-
	1986	4.8	0.7	0.9(0.3)	2.1
	1987	3.5	3.5	2.9(4.9)	3.1
	1988	3.3		2.9(4.2)	-
15.	**Volume of Imports of Goods and Services** (percentage change excluding fuel in brackets)				
	1985	3.0	3.2	3.0(3.5)	-
	1986	5.8	2.1	4.1(4.7)	4.2
	1987	3.8	6.5	4.6(4.9)	5.0
	1988	2.9		3.9(3.3)	-

- The path for **money GDP** growth rises during the forecast period. For 1986-87 growth is somewhat below the path set out in the 1986 MTFS, while for later years money GDP growth is somewhat above this path. (See Table A1.) Much of this overshoot in the growth of money GDP is the result of higher inflation than assumed in the 1986 MTFS. The level of money GDP is below the figure in the 1986 MTFS for 1986-87, almost identical to it in 1987-88, and just over 2 per cent above it in 1988-89. To get closer to the values in the 1986 MTFS for the growth or level of money GDP it would have been necessary to have assumed higher interest rates and/or a tighter fiscal stance.

- For the current financial year there is a direct forecast of the PSBR on the basis of existing tax rates and prospects for public expenditure. For future financial years the forecast assumes the values set out in the 1986 MTFS for the **ratio of the PSBR to money GDP**. The **fiscal adjustments** in these years are as usual allocated to changes in personal income tax.

- Other than for personal income tax, which the fiscal adjustment affects, the forecasters assume constant **tax rates** and (revalorised) allowances throughout and no changes of regime for particular taxes. For instance the North Sea tax regime stays as it now is.

- The forecasters have attempted to produce a realistic path for **public expenditure**, given the current approach to overall fiscal policy. The forecast totals for public expenditure therefore attempt to take account of likely additions to plans in the current and subsequent annual rounds of Ministerial discussions. (A detailed summary of the assumptions on particular components of public expenditure is in Annex A.)

(b) The main results of the forecast

4. Table A1 summarises the principal results of the forecast. It is essential to bear in mind the very large margins of error around the forecast and in particular of projections of the PSBR and of the current account and its constituents. Annex B gives average recorded errors for the main forecast variables in recent years.

Activity

5. GDP growth recovers from 2¼ per cent in 1986 to 2.9 per cent in 1987. The recovery of growth in **manufacturing output** to nearly 4 per cent in 1987, following zero growth in 1986, is more dramatic. With this forecast for growth and the effects of various SEMS (including 'restart') the prospect is for a gentle fall in **unemployment** from 1987.

TABLE A2 GROWTH IN THE UK

		October Forecast 1986	1987	1988
GDP	) Percentage) change on a	2.3	2.9	3.0
Manufacturing Output	) year earlier	0.0	3.9	.4.3
Unemployment (narrow, 000's)		3.2	3.2	3.0

The world economy

6. The UK's recent experience and short term prospects in many ways mirror those in **other G7 economies.** These have experienced greater fall offs in growth of industrial production than in total GNP, and are likely to see more pronounced recovery in industrial output than in GNP. Domestic demand in the G7 grows faster than GDP in 1987 and at approximately the same rate as GDP in 1988. The pick up in activity in the G7 in 1987 is likely to bring with it rises in some (non-oil) commodity prices from their current very depressed levels.

TABLE A3 : THE WORLD ECONOMY

Percentage change on a year earlier	October WEP 1986 (IMF's WEO in brackets)	1987	1988
G7* Real GNP	2.6 (2.7)	3.1 (3.2)	2.8
G7* Industrial Production	1.1	3.9	4.1
G7* Exports of goods	1.9 (1.6)	3.2 (2.3)	4.1
G7* Consumer prices	1.6 (1.9)	1.8 (2.8)	2.8
Imports of NODCs and OPEC	-6.7 (-3.6)	0.1 (0.8)	4.5

*excluding UK

7. The recent mild growth recession in developed economies and the likely recovery is largely the result of developments outside the G7. Both OPEC - dramatically - and other LDCs have been cutting their imports during the past year. Further falls in OPEC imports are likely in 1987 and 1988, but other LDC's imports should start to recover soon, helping to boost G7 exports. The prospect for OPEC imports is conditional on the **oil price** not dropping much below $15. World demand for oil seems to have stabilised during in 1985, after declining for most of the 1980s. It is likely to rise over the whole of the forecast period. The prospects for OPEC being able to strike agreements to keep the price close to $15 for the next two years are reasonable . Thereafter small rises in the real price are likely. There is, however, a threat to oil prices in the very short term because stocks, many of them in tankers, are very high.

Monetary policy and the exchange rate

8. The forecast assumes that the emerging current account deficit and the fears and uncertainties associated with the forthcoming general election will depress the exchange rate. Indeed both factors have almost certainly influenced it already. The sterling index is projected to fall by around 3 per cent during each year over the

forecast period from 68.5 in the fourth quarter of this year. This yields a very slightly improving path from now on for measured competitiveness following the substantial improvements in recent years.

9. With domestic demand strong and an emerging current account deficit it is likely that short term interest rates will have to rise in the near future and thereafter stay high relative to inflation. Base rates rise by one percentage point during the fourth quarter of this year and stay at 11 per cent for the whole forecast period. The mortgage rate goes up by 1¼ percentage points at the beginning of 1987 to 12¼ and stays at that level.

The judgement on interest rates is not the result of placing high weight on the behaviour of broad money and credit. We cannot explain why these have grown so fast and have no clear idea of their significance for activity and inflation. With relatively high nominal interest rates throughout the forecast period, MO growth is expected to stay well within the target ranges set out in the 1986 MTFS.

Inflation

10. Some rise in inflation is very likely as the effects of lower oil and other commodity prices pass through, as earnings fail to decelerate significantly, and as a result of the lower UK exchange rate. Higher interest rates magnify the rise in RPI inflation in 1987, which reaches about 4 per cent by the fourth quarter. RPI inflation rises again to around 5 per cent by 1988(4). Inflation of the RPI excluding mortgage interest payments is likely to be around 3¼ per cent at the end (fourth quarter) of both 1986 and 1987. It rises to over 4½ per cent by the end of 1988.

Public finance

11. The PSBR for 1986-87 is likely to be almost £1½bn higher than the FSBR forecast. This is entirely due to higher public expenditure, with aggregate receipts roughly on track in spite of lower oil revenues.

12. The forecasters expect the planning totals for public expenditure in 1987-88 and 1988-89 to be above the totals published earlier this year by £4½bn and £8bn respectively. This forecast produces falls from now on in ratios of both the planning total and general government expenditure to GDP. However, the ratio of the planning total to GDP does not appear to have fallen between 1985-86 and 1986-87 (though the ratio of general government expenditure to GDP has probably fallen).

While the forecast totals for public expenditure are considerably higher than the levels published earlier this year, they are only a little above the amounts predicted in recent internal forecasts, including the pre-budget forecast this year. The published fiscal projections in the 1986 MTFS had both expenditure and revenue lower than internal forecasts in order to present realistic values of the fiscal adjustment while showing the published plans for expenditure.

13. In spite of what will - correctly - seem very large increases in the public expenditure planning totals, compared with previous published figures, the prospect is for reasonable fiscal adjustments. The fiscal adjustment for 1988-89 is higher than the figure for that year published in the 1986 MTFS. This is because the high totals for public expenditure in the present forecast (compared with recent published forecasts) are offset by higher government receipts partly as a result of putting back the downward revenue adjustment made to the published budget fiscal projections and partly because certain revenues - including non-North Sea corporation tax and National Insurance receipts - are now expected to be very buoyant in the forecast period.

Domestic demand

14. The central expectation of the forecasters is that on present policies **real domestic demand** in the UK will grow more quickly than GDP. The forecast pattern for the UK of higher growth of domestic demand than GDP is not unique. The rest of the G7 as a whole is likely to have the same experience in 1987 at least, though on a smaller scale and with most of the difference between domestic demand and GDP growth being in Japan and Germany, countries with very large current account surpluses and recent dramatic increases in exchange rates. The difference between growth of domestic demand and growth of GDP/GNP is larger in the UK than the rest of the G7 in every year from 1986.

TABLE A4 : REAL DOMESTIC DEMAND AND GDP

(Percentage changes on a year earlier)

	UK				G7 (excluding UK)			
	1980-85	1986	1987	1988	1980-85	1986	1987	1988
Domestic demand	1.2	3.4	3.5	3.3	2.4	3.5	3.4	3.1
Net exports of goods & services (growth contribution)	-0.1	-1.0	-0.6	-0.3	-0.1	-0.9	-0.3	-0.2
GDP*	1.0 (1.0)	2.3 (2.3)	2.9 (3.5)	3.0 (3.0)	2.3+	2.6+	3.1+	3.0+
Potential GDP*	2 (1 3/4)	2¼ (2 3/4)	2¼ (2 3/4)	2¼ (2 3/4)	2 3/4	2 3/4	2 3/4	2 3/4

* Figures for non-oil GDP in brackets
\+ GNP except France and Italy.

There are a number of factors behind the relatively fast rise in domestic demand in the UK compared with the rest of the G7. One such factor is fiscal policy. Table A5 shows that between 1985 and 1986 there has been a loosening in fiscal policy in the UK, as measured by the general government deficit, and that the prospect is for little tightening from now on. In part the recent loosening reflects lower oil revenues which have little direct impact on domestic demand. A tightening in fiscal stance compared with 1985 is likely in the rest of the G7. This is largely the result of discretionary action in the US. (The WEP does not expect Germany to tighten its fiscal stance.)

TABLE A5 : GENERAL GOVERNMENT FINANCIAL DEFICITS AS A % OF GDP

	1982	1983	1984	1985	1986	1987	1988
UK	2½	3½	3 3/4	2 3/4	3¼	3½	3
G7 (less UK)	4	4	3½	3½	3½	3	2 3/4

15. Consumers' expenditure is forecast to show further strong growth over the forecast period. The personal sector saving ratio has fallen recently in response to lower inflation and revaluation to both net financial and tangible assets. Personal saving is likely to remain at a relatively low level over the next few years. Company spending has been relatively weak in 1986 as both stockbuilding and fixed investment have been depressed by the effects on the timing of expenditure of the

tax changes announced in 1984. It is likely to recover to more normal levels in relation to income over the forecast period.

The current account of the balance of payments

16. The current account is likely to be in approximate balance this year and the forecast is for a deficit of £1.8b in 1987, and £3.4b in 1988. The recorded balance on oil trade in the first half of 1986 did not reflect the full effects of the very large fall in the oil price at the beginning of this year. The full effect is being recorded in the second half of the year. The forecast is for the oil balance to deteriorate further from the end of 1987 onwards as domestic oil production declines. Developments in the rest of the current account are not likely to offset the decline in the oil balance. Indeed the non-oil account deteriorates slightly as a worsening of the balance on visible trade, especially manufactures, is greater than the improvement in the balance of invisibles.

TABLE A6 - THE UK CURRENT ACCOUNT (£b.)

	Total	Fuel+ Oil+	Manufac-	Other	Services	IPD+	Transfers	Current
1980-84*	1.6	1.9	1.3	-5.0	3.5	4.2	-2.1	3.5
1985	3.1	4.5	-3.0	-5.8	5.8	7.0	-3.5	3.6
1986	1.7	2.7	-5.2	-6.0	5.3	7.1	-2.6	0.3
1987	0.9	1.9	-7.1	-5.9	5.2	8.4	-3.3	-1.8
1988	0.1	1.3	-8.1	-6.3	5.3	8.9	-3.3	-3.4
1989	-0.7	0.5	-9.6	-6.6	6.0	9.5	-3.4	-4.8

* annual averages
\+ contribution of North Sea oil defined as visible trade less North Sea profits due abroad. The latter is therefore excluded from IPD.

(c) Main issues

17. Three aspects of the forecast in particular merit attention because of their implications for prospects and policy; these are the projected

rising current account deficit,

the fall in unemployment,

and the **large fiscal adjustments,**

18. The current account would be stronger with some combination of

(a) a higher world oil price,
(b) stronger world demand, though higher commodity prices could in part offset the effects of this,
(c) lower growth of UK domestic demand,
(d) better than assumed measured competitiveness,
or (e) better trade performance for given determinants.

19. The forecasters expect a trade performance for given determinants - world and domestic demand and the level of measured competitiveness - to be close to the average for the last three years. They therefore assume better performance than in the 1970s or early 1980s, though no further improvement in the future. The forecast does not for instance assume a surge in imports on the scale recorded during past periods of high consumption growth, nor do the value shares of exports in world trade or imports in TFE decline.

20. **Unemployment** is forecast to start falling during 1987. Adult unemployment is about 380 thousand lower at the end of 1988 than it is currently. SEMS and Restart reduce adult unemployment by around 100,000 over this period. Non oil output growth of around 3½ per cent a year on average, with productivity growth in the non-oil economy at under 2 per cent, leads to the creation of some 870,000 new jobs between the fourth quarters of 1986 and 1988, including a small increase in manufacturing employment. This compares with a forecast rise of around 470,000 in the total working population (claimant unemployed plus employed labour force) over this period.

21. The relatively high **fiscal adjustments** in the forecast are not a major factor behind the projected strong growth in domestic demand. If extra public expenditure or, for instance, lower national insurance contributions preempted the whole of these fiscal adjustments, thus leaving no scope for cuts in direct personal tax, the direct effect, on the assumptions used in the forecast, would be to change the composition of domestic demand, but not necessarily its overall growth. But the size of the fiscal adjustments are important for the detailed operation of fiscal policy. It is therefore worth noting why the forecasters project as large fiscal adjustment in 1988-89 in spite of the assumption that the planning total will be considerably greater than the previously published total.

22. The most important single factor explaining the large fiscal adjustment forecast for 1988-89 is the enormous flow surplus of just under 10 per cent) in the **National Insurance Fund**, even with the assumption of a sharply reduced Treasury supplement. The projected fall in unemployment from 1987 in part explains the high 1988-89 flow surplus. But more important is the high growth in contributions as a result of the fast rising wage and salary bill while benefit rates tend to be linked to prices. If national insurance contributions were set at rates to achieve lower surpluses this would not much affect the growth of total domestic demand, but it would reduce the fiscal adjustment.

B : THE WORLD ECONOMY

The Oil Market

23. The fall in **world oil demand** seems to have ended during 1985, and oil consumption shows signs of having risen this year, perhaps by 2½-3 per cent. Demand could increase significantly in the medium term if oil prices remain low, spurred by a slowing in the rate of progress on energy conservation and some substitution of alternative fuel sources. This is likely to be accompanied by a slowdown in the rate of expansion of non-OPEC oil supply as marginal production is shut in and other fields are depleted more slowly. However, sharp reductions in output are not likely until cutbacks in new exploration and appraisal investment begin to affect production capacity, probably not until the 1990s.

24. OPEC oil production, which reached the heights of 20½-21 million barrels per day (mbd) during the summer, has now been reined back to about 17 mbd under a short-term production agreement covering September and October. The OPEC members seem to have been seriously alarmed by the fall in oil prices to below $10 and its effect on their revenues, and the chances of further quota restrictions being agreed and adhered to are consequently increased. The forecast assumes therefore that OPEC will maintain sufficient discipline, with the cooperation of some non-OPEC countries, for prices to settle just below $15 per barrel for most of 1987. There could be fluctuations around that price, and in particular there is some risk of weakness in the short term as a result of the excess production during the summer and the consequent build-up of stocks, some in the form of floating storage.

25. The projections for oil demand and non-OPEC supply together result in a residual demand for OPEC oil which rises to an average of nearly 20 mbd in 1987. The position is quickly reached therefore where the majority of OPEC countries can raise their production levels without imposing a burden of restraint upon Saudi Arabia. This may lead to real increases in the price of oil in the later years of the forecast period; the forecast projects a constant real price for 1988 followed by small increases of about 3 per cent per annum. Table B1 summarises the forecast for demand and production.

TABLE B1 : THE WORLD OIL MARKET

Millions of barrels per day	1982	1983	1984	1985	1986	1987	1988
World demand (incl. stockbuilding)	45	44½	45¾	45½	47½	48¼	50
Non-OPEC supplies	25	26	27¼	28¼	28	28½	29
OPEC production	19¾	18½	18½	17¼	19½	19¾	21¼

Activity and Trade

26. World activity has not as yet responded to lower oil prices as expected earlier in the year. It is clear that the negative effects on output, from lower oil investment and production activity in the major economies and cutbacks in imports by the OPEC countries, have come through much more quickly than the beneficial influences on activity from lower inflation. This short-term weakness shows up more particularly in the industrial production figures, and less so in recent movements in real GNP. Industrial production has been fairly flat in each of the G7 countries over the past six months; yet real GNP in these economies as a whole appears to have been about 2½ per cent higher in the second quarter of 1986 than a year earlier, not far below the 1985 growth rate. This growth derives substantially from domestic sources - especially consumers expenditure - while exports remain weak; domestic demand growth in the G5 economies has been in the 3½-4 per cent range in recent quarters.

27. Despite the lack of evidence of such as yet, it is likely that activity growth will be higher in the second half of 1986 and during 1987. Strong real incomes, falling inflation and low nominal interest rates should generate further growth in consumers' expenditure next year, already rising strongly. Business investment may remain sluggish, reflecting low levels of capacity utilisation in many countries and the maturity of the US business cycle. Growth in G7 industrial production is likely to rise by more than GNP.

28. There is a danger that domestic activity in the US may slow in 1988, hit by the impact of the falling dollar on consumer price

inflation and by a steady rise in short-term interest rates stemming from failure to reduce the Federal budget deficit as much as desired. An improved external performance as a result of the dollar's depreciation should counter the effects of policy tightening to some extent. Growth in Japan and Germany will be concentrated much more than in the past on domestic demand in 1987 and 1988, as their trade positions suffer from rapid currency appreciations over the past eighteen months. Although fiscal and monetary policies will generally remain tight in both countries, some easing will be necessary to generate the additional domestic growth. This might entail small cuts in interest rates, although possibly not until next year, and some fiscal packages, perhaps rather larger than the token Yen 3.6 trillion on construction measures recently announced by the Japanese government. The forecast assumes that Germany partially relaxes its announced medium term fiscal targets. German domestic demand is already showing some signs of resilience in the face of falling price levels but the Japanese, with a long tradition of export-reliance and a high propensity to save as well as a large currency adjustment to overcome, may respond rather more slowly.

29. World trade has also turned out weaker than expected, especially trade in manufactured goods which barely rose at all in the second half of 1985 and the first part of 1986. Among the reasons for this are cutbacks in imports into oil-producing countries and the effect of weak commodity prices and low capital inflows on other developing countries' import demand. There are no firm figures on the extent of OPEC and LDC cutbacks in imports, but real G5 exports to OPEC and to non-oil developing countries in the first five months of 1986 were respectively 16 per cent and 8 per cent lower than a year earlier.

TABLE B2 : WORLD TRADE

(percentage change on previous year)

	1984	1985	1986	1987	1988
Total world imports	8	3	4½	4	4½
of which:-					
- OPEC	-9	-15	-22	-29	-11
- developing countries	7	3	-2	8	7
UK export markets for manufactures	8½	4½	2	4½	4½

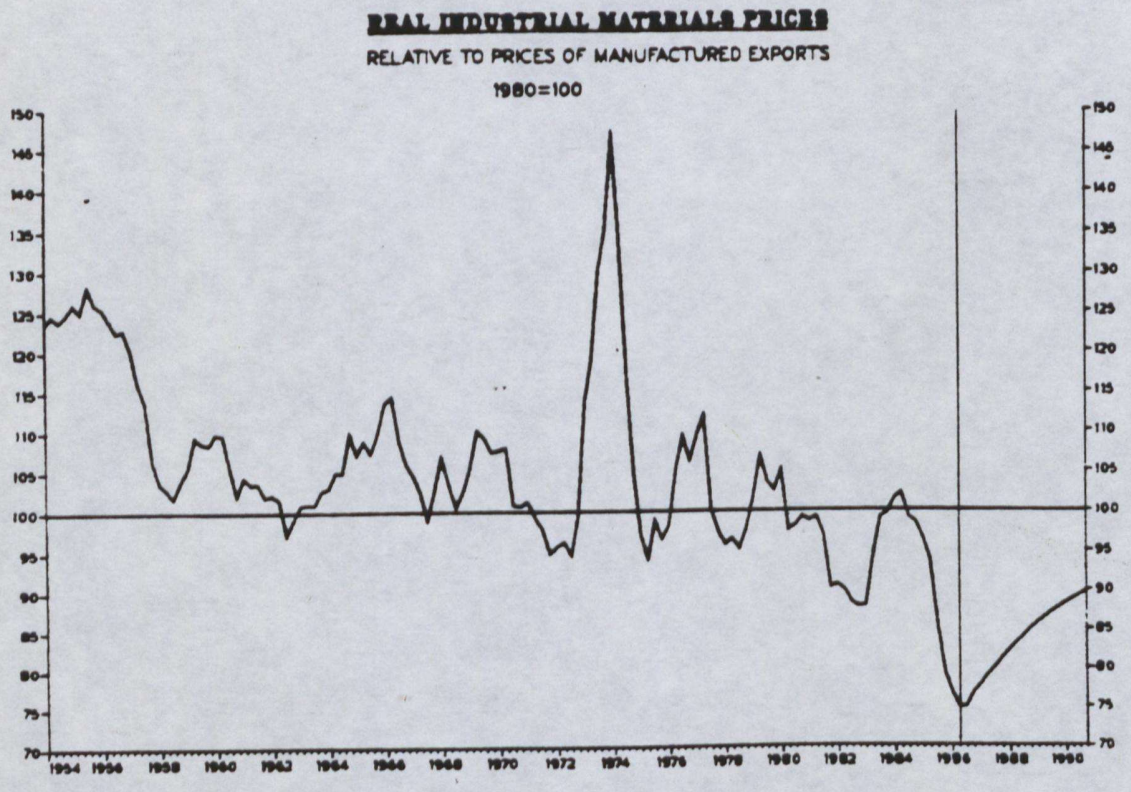
30. Indications for the second quarter of 1986 show some substantial increases in imports into the major economies, particularly the US and Japan, some of which may be a rebuilding of oil stocks. Since the weakness in demand outside the OECD area is depressing G5 exports below total world trade growth, the corollary is that non-OECD exports are rising much more quickly. However there is no specific data to support this hypothesis. Already the rise in demand for oil is likely to be increasing OPEC exports, and NODCs may benefit from strong OECD domestic demand growth. Combined with the effects of the predicted rise in commodity prices, this growth in non-OECD exports should translate into strong rises in imports into the developing world. This rise is likely to occur soon for non-oil producing countries, having already undergone a fairly complete import adjustment to falls in commodity prices over the past year, but OPEC countries will need to continue cutting back sharply on their imports next year in the face of rising current account deficits. (See Table B2.)

31. Total world trade is therefore expected to rise by 3½-4 per cent in 1987, and slightly faster thereafter. G7 exports will recover more slowly as demand rises in the developing world (see Table A3). Trade in manufactures should exhibit a stronger cyclical upswing, but as usual UK markets will suffer from their relative dependence on OPEC markets that they will remain depressed for the next year or so.

32. The forecasts for trade and activity in the developed world are similar to those just published by the IMF in their latest World Economic Outlook (see Table A3), although the WEP projections for NODCs show a stronger recovery in import demand. The upturn in world activity currently projected by WEP and the IMF is, as Table A3 shows, weaker than WEP expected in June.

Inflation

33. Real non-oil commodity prices have continued to fall to historically low levels - real industrial materials prices are now at their lowest post-war level (see chart below) and food prices are also very weak. Together with the fall in oil prices, this has contributed significantly to the fall in the rate of consumer price inflation in the G7 economies to its lowest level for over twenty years; consumer and wholesale price levels in Japan and Germany are now lower than a year ago.



34. Once the benefits of lower oil prices have fully passed through into final goods prices, the rate of inflation will pick up again next year. A recovery in commodity prices may augment the expected rise in consumer and wholesale prices as world activity expands. Already prices of industrial materials have shown signs of firmness, and they are likely to rise, although the availability of extra production capacity should prevent a dramatic recovery. Food prices on the other hand are likely to remain weak in the face of mounting subsidies and overproduction in the US and the EC in particular. A firm macroeconomic policy framework in the major countries and some likely deceleration in earnings in the major economies will constrain the extent of the likely rise in inflation.

C : PUBLIC FINANCES

35. The forecast is summarised, and compared with the FSBR forecast, in Table C1. Rather more detailed tables, giving more detail on expenditure and receipts, will on previous practice appear in the Autumn Statement for 1985-86 and 1986-87.

TABLE C1 : PUBLIC SECTOR BORROWING - £ billion

	1985-86	1986-87		1987-88		1988-89	
		FSBR	Oct	FSBR	Oct	FSBR	Oct
General Government Expenditure	158.7	163	165	170	173	175	183
General Government Receipts	151.8	156	156	164	168	174	183
Fiscal adjustment:							
(i) From previous years	-	-	-	-	-	2	2
(ii) Annual	-	-	-	2	2	4	6
GGBR	6.8	7	9½	8	8	7	7
Public corporations' overseas and market borrowing	-1.0	0	-1	-1	-1	0	0
PSBR	5.8	7	8½	7	7	7	7

36. The forecast of the PSBR in 1986-87, revised up in June, has been increased further to about £8½ billion, about £1 billion above the FSBR projection. General government expenditure is £2 billion higher than in the FSBR, mainly due to an overrun on the planning total. Total receipts are still forecast at the same levels as in the FSBR, but oil taxation is down nearly £1 billion and non-oil receipts are up a similar amount. The main offset to higher expenditure is lower public corporations' borrowing from the market and overseas. This partly reflects an improved public corporation performance.

37. In 1987-88 and 1988-89 both general government expenditure and receipts have been revised upwards, compared with the Budget; in 1987-88 by roughly equal amounts leaving the fiscal adjustment unchanged at £2 billion, and in 1988-89 revenues by more than expenditure producing a higher fiscal adjustment. To a large extent the upward adjustments to both sides of the account do not represent

genuine changes to the forecast but the removal of presentational changes made to the numbers published in the FSBR. (These are discussed further below.) The much larger fiscal adjustment of £6 billion for 1988-89 is some £2 billion higher than in the MTFS, but similar to the assessment made (but not reported) in June.

38. The conventional practice made in the forecasts is to allocate any fiscal adjustment to personal income taxes, but this may significantly overstate the scope for income tax cuts in practice. One reason for this is that the forecast has substantial surpluses on the National Insurance Fund, despite assuming the maximum permitted reductions in the Treasury Supplement from 1987-88 onwards. Such surpluses are unlikely to be sustainable in practice and their scale is such that any action to diminish them will almost certainly have to include reductions in contributions. Only if employers' contributions were reduced - with the resulting effect on costs -, however, would there be an effect on the rest of the forecast, apart from the fiscal adjustment. The effects on domestic demand of reducing employees' national insurance contributions are in most respects identical to those of reductions in personal income tax.

39. It is not easy to explain fully why such a large fiscal adjustment is forecast for 1988-89. The surplus on the national insurance fund stems in part from falling unemployment, in part from the linking of contributions to earnings and benefits to (slower growing) retail prices and in part to an assumption that the incentive for employers to contract out will be less in 1988-89. Another major factor behind the large fiscal adjustment, accounting for over £½ billion, is a projected fall in net EC contributions in 1988-89.

Public expenditure

40. For 1986-87 GEP's September position report anticipated an overspend on the planning total in the 1986 PEWP of £1.4 billion. This forecast has added an extra £0.4 billion for Rover and £0.1bn for net EC contributions and local authority current, giving an overspend of £2.0 billion. GEP's October position report will be circulated at the end of next week.

41. For later years the forecasters build up a forecast for public expenditure to a considerable extent independently of the agreed, or

likely to be agreed, plans in the current round of Ministerial discussions. The totals take account (i) of differences between the economic assumptions used in the survey and the economic prospects as this forecast sees them, and (ii) other pressures on programmes which past experience suggests are likely, particularly pressures which are likely to be reflected in upward revisions to programmes in the 1987 survey.

42. The forcasters' view of the planning total is summarised in Table C2. It is assumed that privatisation proceeds from 1987-88 onwards are £½ billion a year higher than in the 1986 PEWP, at £5 billion per annum. There appears to be some doubt as to whether the planning total will fall in relation to money GDP this year but a declining profile thereafter seems achievable.

TABLE C2 : PLANNING TOTAL - £ billion

	1985-86	1986-87	1987-88	1988-89
1986 PEWP	134.2	139.1	143.9	148.7
October Forecast	133.6	141.1	148.1	156.7
(as % of GDP)	37	37	36¼	35½
General Government expenditure as % of money GDP	44	43½	42½	41½

43. The implication of the October Forecast is that the planning totals in the 1986 PEWP were much too low. Even with the forecast overspending however, the planning total is projected to fall each year from now on as a percentage of money GDP. This would be so even if privatisation proceeds were omitted from the definition of the planning total.

44. The largest contribution to overspending thus defined is from local authority current expenditure, despite large upward revisions agreed for the current survey. This is the result of assumptions that

(i) local authority manpower will start to rise,

(ii) teachers get Coventry and other local authority workers pay increases in line with the private sector,

(iii) the authorities will be willing to finance their spending with rate increases consistently and significantly above the general rate of inflation.

45. The forecast overspend on social security reflects higher exogeneous take-up of benefits than in the PEWP, partially offset in 1988-89 by lower unemployment than assumed in the PEWP.

TABLE C3 : FORECAST CLAIMS ON THE RESERVE £ billion

	1986-87	1987-88	1988-89
Social Security	1.2	1.8	2.3
Central government pay	-	0.6	1.7
Other central government current expenditure	0.2	1.1	2.2
Local authority current	2.8	4.8	7.2
Local authority capital	0.5	0.7	0.7
Nationalised industry EFLs	-	0.6	1.2
Other	1.8	1.3	1.1
Privatisation proceeds	-	-.3	-.3
1986 PEWP Reserve	-4.5	-6.3	-8.0
Overspend on PEWP planning total	2.0	4.3	8.1

46. The prospects for general government expenditure (GGE) are summarised in Table C4. As in the MTFS a falling ratio of GGE to money GDP is forecast.

TABLE C4 : GENERAL GOVERNMENT EXPENDITURE

	1985-86	1986-87	1987-88	1988-89
FSBR*				
£ billion	157.7	163.4	169.5	174.7
% of money GDP	44.1	42.7	41.7	40.5
October Forecast				
£ billion	158.7	165.3	173.1	182.6
% of money GDP	44.0	43.5	42.4	41.4
Change since FSBR				
£ billion	1.0	1.9	3.6	8.0

(* figures shown are the unrounded internal figures)

47. The level of General Government cash expenditure in each year is significantly higher than projected in the FSBR. There are two main reasons for this.

First the internal forecast of the planning total at the time of the budget was well above the 1986 PEWP but it was decided to stick to the PEWP figures in public. This had the effect of reducing GGE, compared with the internal forecast, by £1½ billion in 1987-88 and £2 3/4 billion in 1988-89. (To prevent this presentational downward adjustment affecting the fiscal adjustment an offsetting downward adjustment was made to general government receipts.)

Secondly the October Forecast has higher inflation and interest rates compared with the MTFS. The level of the GDP deflator in 1988-89 in the October Forecast is 1¼ per cent higher than in the MTFS, while interest rates are around 2½ percentage points higher.

48. Table C5 shows the forecasters' view of both the planning total and GGE in real terms (ie cash deflated by GDP deflator).

TABLE C5 : PUBLIC EXPENDITURE IN REAL TERMS

	Average annual percentage change	
	3 years to 1986-87	2 years to 1988-89
Planning Total		
MTFS	1.9	0.9
October Forecast	2.3	0.8
GGE		
MTFS	2.2	0.9
October Forecast	2.5	0.5

General Government Receipts

49. In contrast to general government expenditure which is expected to fall as a share of money GDP, general government receipts are projected to be flat relative to GDP, after falling relatively this year due to the fall in oil prices. The main elements of receipts are shown in Table C6.

TABLE C6 : GENERAL GOVERNMENT RECEIPTS

	% share 1986-87	% change 1986-87	% change 1987-88	% change 1988-89
Personal income tax*	.24	6	10	9
Non-North Sea corporation tax	.06	19	21	21
Expenditure taxes	.30	7	7	8
Taxes on capital	.02	18	17	8
Total Non-NS Taxes	.62	8	10	10
North Sea Taxes	.03	-55	-20	-2
National insurance	.17	7	8	10
Total CG taxes and NICs*	.82	2	8	10
LA rates	.10	12	10	9
Other receipts	.08	-3	-1	-4
Total	1.00	2½	7½	9
Money GDP		5½	7½	8

* before fiscal adjustments

50. Effective tax rates - defined as tax accruals as a share of the relevant income which proxies in the forecast for the tax base - are rising slightly, both for the personal income tax as a result of real fiscal drag, and non-North Sea corporation tax, reflecting, among other things, a diminishing overhang of losses from previous years offsettable against tax.

D : INTEREST RATES, THE EXCHANGE RATE, COMPETITIVENESS AND FINANCIAL CONDITIONS

Interest rates and exchange rate

51. The sterling index has fallen 17 per cent since the second half of 1985. According to the forecasters', admittedly very uncertain, ready reckoners the fall in oil prices has resulted in a fall in the index of 10 per cent. The remaining 7 per cent can be attributed to a variety of factors including the growth of domestic money, credit, and labour costs and, more recently, the shadow of the next general election and

the prospect of a deterioration in the non-oil current account. The latter two factors are likely to assume increasing importance.

52. Although market sentiment can change quickly, it would be surprising therefore if, given the scale of the fall in the oil price during 1986 any reversal in the nominal exchange rate in the foreseeable future was other than small and temporary. The forecast assumes that the sterling index will be on a downward trend of 3 per cent a year. Even if this projection proves roughly correct there could well be a lot of variation either side of the trend.

TABLE D1 : PROSPECTS FOR EXCHANGE RATES

	Sterling Index	$/£	DM/£	Real Exchange Rate* (1985=100)
1983) 1984) averages 1985)	78¼	1.30	3.79	100
1986 Q4	68½	1.47	2.89	87
1987 Q4	66½	1.51	2.67	86
1988 Q4	64½	1.51	2.51	85
October 9	67.1	1.42	2.83	(83) estimate

* using relative GDP deflators.

The chart in section F shows various measures of competitiveness. None of these improves by much over the forecast period.

53. With prospects for the exchange rate as they are, the short term interest differential in favour of sterling may well have to remain at the 4 percentage points it averaged in 1985, and even higher for a time. If world interest rates in general are at a trough, as assumed in the WEP, this suggests little scope for UK rates to fall below current levels. The forecasts of money GDP and narrow money discussed elsewhere in the report point to much the same picture. The forecast is for 3 month rates at 11 per cent throughout. This implies a rise in the mortgage rate from its current 11 per cent to something like 12½ at the beginning of 1987.

TABLE D2 : INTEREST RATES

	3 month rates		Mortgage Rate	20 year gilts
	World Market	UK		
1985 average	8¼	12¼	13¼	10½
1986 Q4	5 3/4	11	11	10¼
1987 Q4	6	11	12¼	10 3/4
1988 Q4	6½	11	12¼	11¼
October 8	6½	11	11	10½

Monetary Aggregates and Credit

Table D3 summarises the forecast of the monetary aggregates.

TABLE D3 : MONETARY AGGREGATES

(Average annual growth rate during financial year)

	MO		£M3		PSL2
	MTFS range	Actual/ Forecast	MTFS range	Actual/ Forecast	Actual/ Forecast
1985-86	-	4½	-	13¼	12 3/4
1986-87	2-6	3 3/4	11-15	18¼	13½
1987-88	2-6	4	-	13 3/4	10 3/4
1988-89	1-5	3½	-	13½	11
Banking Sept*		4½		18¼	14¼

*Growth on a year earlier

54. With no evidence that there is lightly to be a change in its trend velocity, the forecast projects fairly steady MO growth, at a little below 4 per cent a year after mid 1987, reflecting continued growth in personal incomes and expenditure, and constant nominal interest rates.

55. The forecast claims no new insight into the recent rapid growth of £M3 and assumes that it has no major implications for prices or economic activity, although it may have contributed to market worries about sterling. Similarly the projection of £M3 has no significant implications for the rest of the forecast. The forecast of £M3 growth

in 1986-87, together with the near halving of money GDP growth this year, implies a fall in velocity of 10 per cent, over four times the average rate of decline in recent years. The falls in velocity in future years are much lower, though above the average of recent years. PSL2 growth has picked up to a much smaller extent but the forecast of a gradual deceleration from now on is heavily dependent on the very uncertain view of £M3.

56. The growth of credit carries on remorselessly, with little sign of any responsiveness to interest rates or money incomes. The forecast implies further rises in debt/income ratios.

TABLE D4 : THE GROWTH OF LENDING (per cent)

	Bank lending to private sector	Building Society lending	Bank and Building society lending
1985-86	17 3/4	18¼	18
1986-87	18	19¼	18½
1987-88	17	17¼	17
1988-89	16	14 3/4	15½

Sectoral surpluses and deficits

Table D5 shows forecast of sector financial surpluses and deficits.

TABLE D5 : SECTORAL SURPLUSES (DEFICIT)

		ICC's					
	Personal Sector	North Sea	Other	Financial Companies	Total Private	Public Sector	Overseas
1985-86	9.7	-1.0	7.4	0.1	16.3	-8.4	-4.3
1986-87	8.2	-1.4	9.7	-1.1	15.3	-12.5	0.6
1987-88	7.6	-0.4	7.1	-1.0	13.3	-12.5	2.4
1989-89	7.8	-0.4	5.9	-0.9	12.5	-12.5	3.4

57. The projected fall in the personal sector surplus partly reflects the fall in the saving ratio discussed earlier. The personal sector continues to build up its gross debt/income and gross liquidity ratios. Income gearing is high but not yet a major constraint on borrowing.

The forecast fall in non-North Sea ICCs' surplus should not impose any great strains overall, as ICCs liquidity ratios are high historically and access to finance as easy as it has ever been.

58. The deterioration in the UK current account, the move of the overseas sector from deficit to surplus ie has implications for the composition of capital flows. The main structural capital flows are not likely to change much over this period - in particular the outflow on non oil net direct investment is projected to remain at around £2bn per year, similar to the underlying real outflows since the early 1970s, and the net outflow of oil direct investment is projected flat at the 1985 level of £½bn.

59. The counterparts in the capital account to the deterioration of the current account are;

(i) a fall in outward portfolio investment (excluding banks) from £8bn in 1985 to £5½bn in 1988 reflecting at least partly improving yields in the UK relative to overseas. Projected currency movements which point to more favourable revaluation effects on the stock of overseas assets than experienced during 1985, also suggest that the maintenance of the share of overseas assets in portfolios would not require such large direct outflows as recorded recently.

(ii) a rise in inward portfolio investment (excluding gilts) of £^{3}/4bn, again reflecting changes in yields and revaluation effects on the stocks.

(iii) a rise in the net inflow on UK bank foreign currency and sterling transactions (including their outward portfolio investment) of £3bn generated in part by a widening of the short term interest rate differential in favour of sterling. The largest component of this is a rise of £2bn is non residents sterling bank deposits.

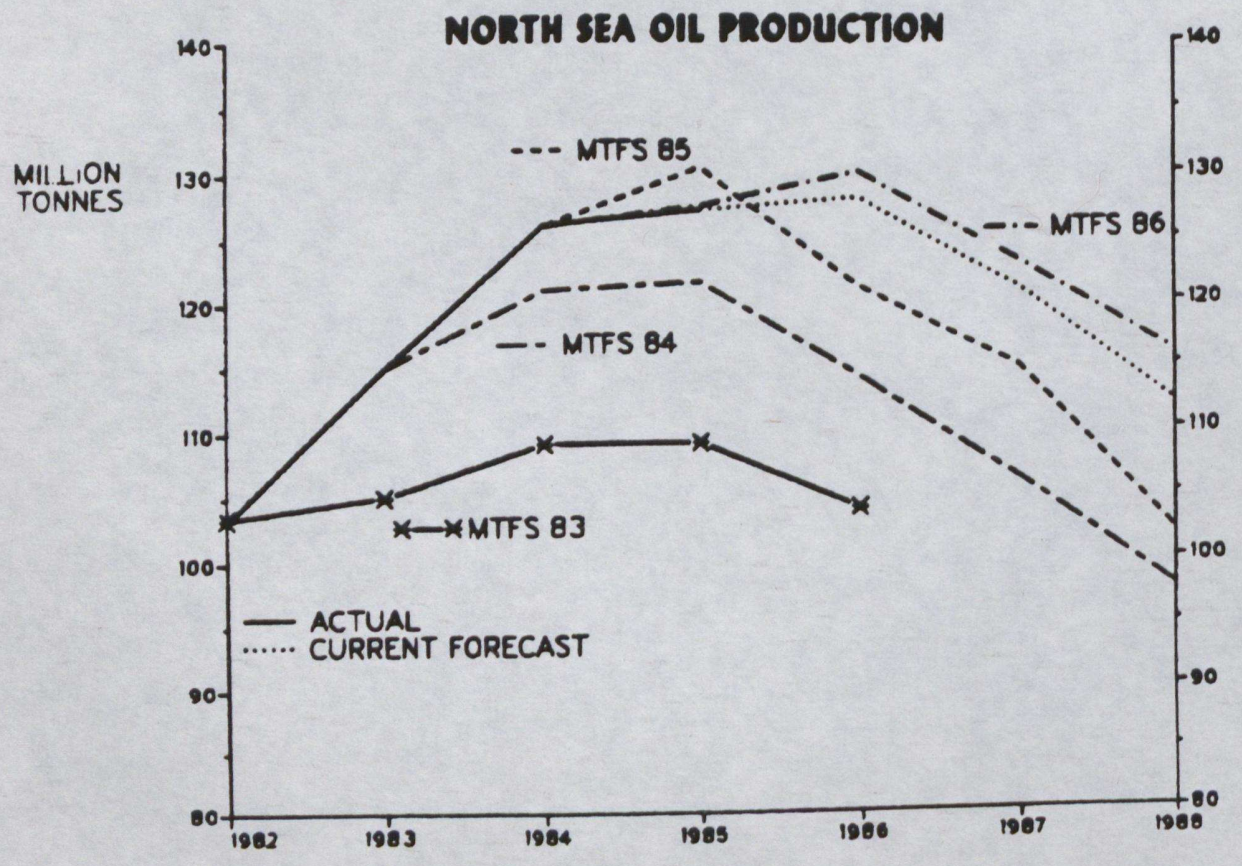
60. The forecast therefore implies a turnaround in identified capital flows from a net outflow of £6bn in 1985 to a net inflow of £1½bn in 1988. However revaluations and the assumption that recent gains in the US stock market will be sustained, associated in part with the depreciation of sterling, are expected to be sufficient to ensure a steady rise in UK net overseas assets from £80bn at the end of 1985 to £120bn at the end of 1988.

E : THE NORTH SEA FORECAST

61. The Brent spot price has averaged $14 per barrel since the short-term OPEC production agreement in early August. The forecast assumes that, against a background of a relatively stable oil market and a world oil price just below $15 per barrel, a small North Sea premium will re-emerge with Brent trading at an average of $15 per barrel over the next twelve months.

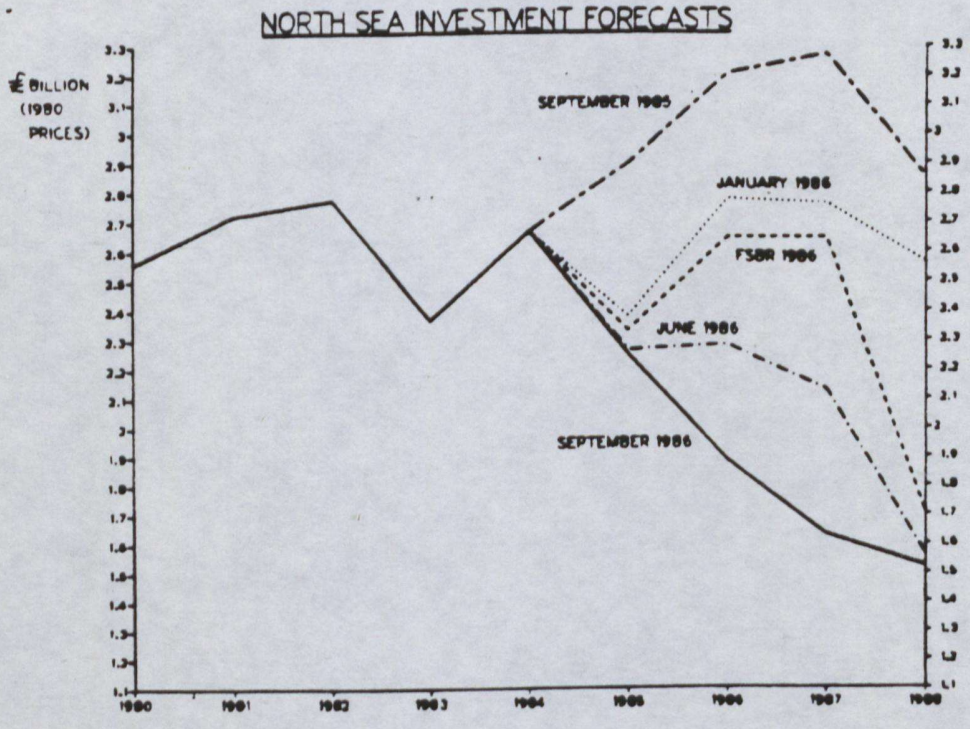
Production

62. Recent forecasts of North Sea production are compared in the chart below. Production is likely to peak at 128 million tonnes in 1986, only 3/4 million tonnes higher than in 1985 and 2 million tonnes lower than forecast (though not published) in the 1986 FSBR. DEn attribute the downward revision to technical factors unrelated to low oil prices. In the later years of the forecast, however, the lower production profile shown in the Chart reflects a considered assessment of the effect of lower prices. The revised path is still close to the centre of the range published in the 1986 Brown Book.



Capital Expenditure

63. The forecast path for the volume of North Sea capital expenditure has been revised down steadily over the past year (see chart below) in the light of the much lower than anticipated outturn in 1985 and the fall in the oil price. The current forecast is based on the 1986 NEDO investment intentions survey for the North Sea, which is the first comprehensive assessment of company plans since the oil price fall. It suggests that investment could be even weaker than previously expected in 1986 and 1987. The North Sea tax forecast is affected by capital expenditure in current prices. This may well be further held down over the next few years by cost reductions as well as volume cuts. The forecast projects a reduction in North Sea investment prices relative to other prices of 15 per cent over the next three years.



Government revenues

64. Government revenues from the North Sea in 1986-87 are now expected to be £5.1bn, £0.4bn lower than forecast in June (and £1bn below the FSBR forecast) because of lower production in 1986 and because the Brent price since June has been, on average, lower than the $15 per barrel we were then assuming. For 1987-88 the revenue forecast is unchanged at about £4bn but there are downward revisions to later years, mainly due to the lower production path.

TABLE E1 : GOVERNMENT REVENUES FROM THE NORTH SEA

(£ billion)

	FSBR	June	October
1985-86	11.5	11.3	11.3
1986-87	6.1	5.5	5.1
1987-88	4.0	4.1	4.0
1988-89	4.2	4.7	4.0

The oil trade balance

65. The same factors have led to a downward revision of the forecast for the oil trade balance (see Table E2). This is likely to fall from £9.3bn in 1985 (coal strike adjusted) to £4.2bn in 1986. Thereafter a slow decline to £2.8bn in 1988 is projected, reflecting the decline in North Sea production and some rise in domestic consumption in response to lower oil prices and rising activity. The fall in the contribution of the North Sea to the current account is smaller than suggested by these figures, because of a partially offsetting reduction in North Sea profits due abroad: the underlying net contribution is projected to fall from £5.6bn in 1985 to £2.7bn in 1986 and £1.3bn in 1988.

TABLE E2 : OIL CONTRIBUTION TO THE CURRENT BALANCE*

(£ billion)

	FSBR	June	October
1985+	5.6	5.6	5.6
1986	2.9	3.0	2.7
1987	1.8	1.9	1.9
1988	1.8	1.8	1.3

*Visible oil trade balance less North Sea profits due abroad.
+Coal strike adjusted

F : TRADE AND THE BALANCE OF PAYMENTS

Recent Performance

66. The current account has been in broad balance so far during 1986, though it has been deteriorating through the year. Measured at constant prices the balances of trade in manufactures and services have both deteriorated sharply this year: in the case of manufactures reverting to a more familiar trend after two relatively good years, in

the case of services interrupting a trend that has generally been favourable in recent years.

TABLE F1 : BALANCES OF TRADE AT CURRENT AND 1980 PRICES

(£ billion)

	Current Prices		1980 prices	
	Manufactures	**Services**	**Manufactures**	**Services**
1982	2.3	2.6	+1.8	2.2
1983	-2.4	3.7	-2.2	3.2
1984	-3.8	3.7	-3.0	3.3
1985	-3.0	5.8	-2.7	4.5
1986	-5.2	5.3	-4.2	3.4

67. Most G7 economies are experiencing substantial deteriorations in their net trade positions at constant prices this year. The falls in both oil and non-oil commodity prices have at one and the same time stimulated industrial countries' demand, and hence imports, and reduced the amount of money that OPEC countries and the developing countries have available to spend on industrial countries' exports. For these industrial countries the effect of this real deterioration in net trade on the current account has been more than offset by the terms of trade gain associated with the fall in oil and other primary commodity prices. The UK's non-oil terms of trade improved in 1986, but this effect was swamped by the effect on the UK's terms of trade of the fall in oil prices.

68. The effect of lower oil prices does not, however, seem to be the whole explanation for the deterioration in the UK current account this year. Netting off the effects of lower oil prices on oil IPD debits, the decline in the North Sea oil contribution to the current account has been responsible for £3 billion of a forecast underlying deterioration of more than £5 billion in the UK current account this year. Table F2 shows the recent and forecast underlying performance of the current account. It is the deterioration in the underlying non-oil account after relative stability in the last few years that is the most notable feature of the forecast.

TABLE F2 : CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

(£ billion)

	Current Account	Coal Strike Effect	Ec refunds	Underlying	Oil contribution*	Underlying non-oil
	(1)	(2)	(3)	(4)	(5)	(6)
1983	3.1			3.1	4.1	-1.0
1984	1.2	2.8		4.0	6.1	-2.1
1985	3.6	1.3	0.4	5.3	5.6	-0.3
1986	0.3		-0.4	-0.1	2.7	-2.8
1987	-1.8			-1.8	1.9	-3.7
1988	-3.4			-3.4	1.3	-4.7

(4) = (1)+(2)+(3); (6) = (4)-(5)

69. Partly because of the substantial gain in competitiveness experienced by the UK during the second half of 1986, the current account shows virtually no underlying deterioration during next year from the position reached in the second half of 1986, other than that attributable to having a full year of low oil prices and some reduction in North Sea output. Thereafter the underlying current account deteriorates further because of

(i) the gradual rundown in North Sea production:

(ii) the well established tendency of the UK to lose share (in volume and to a lesser extent in value terms) in domestic and overseas markets; there is some evidence that this tendency has become less pronounced recently and the forecast gives some weight to this evidence in projecting these shares:

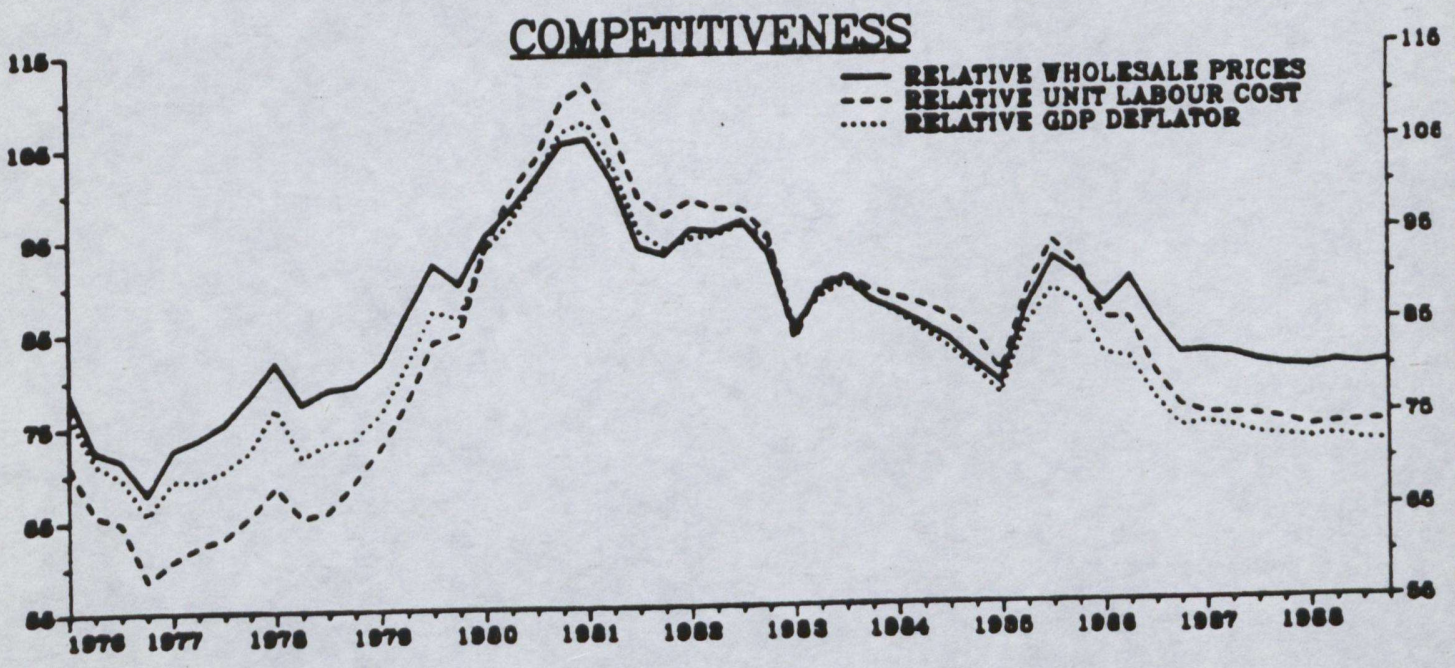
(iii) high UK domestic demand growth relative to the growth of its potential output in comparison with the rest of the G7 (see Table A4):

*Net oil exports less IPD oil debits less coal strike effect on net oil exports.

(iv) comparatively weak export markets in which the UK is very competitive, for instance OPEC and some other countries, especially South Africa and Australia:

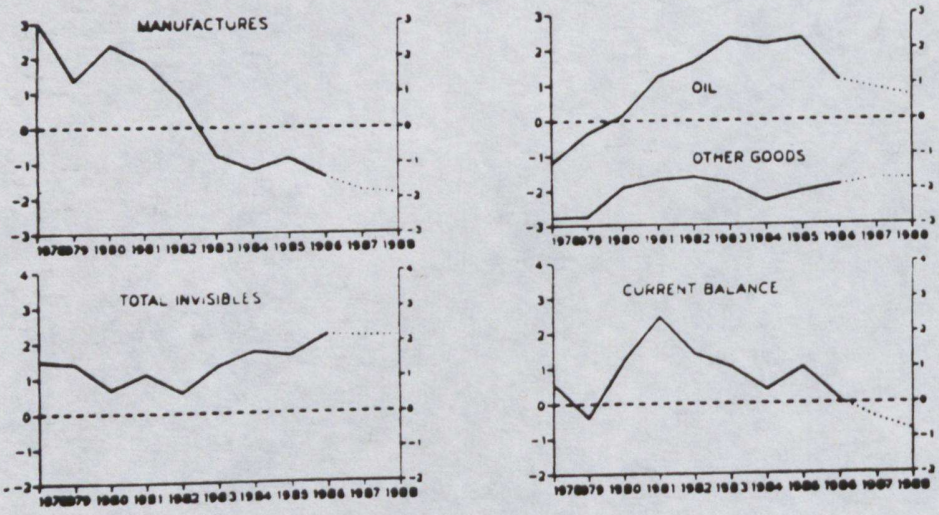
(v) a forecast recovery of non oil commodity prices from their exceptionally weak levels of the recent past (world industrial materials prices rise by 4½ per cent a year between 1986 and 1989):

Against these effects sterling income from overseas assets over the forecast period improves as a result of the fall in the exchange rate (though this does not secure much further improvement in measured competitiveness).



70. The forecasts of the various components of the current account are summarised in the next chart.

TRADE BALANCES AS SHARE OF GDP

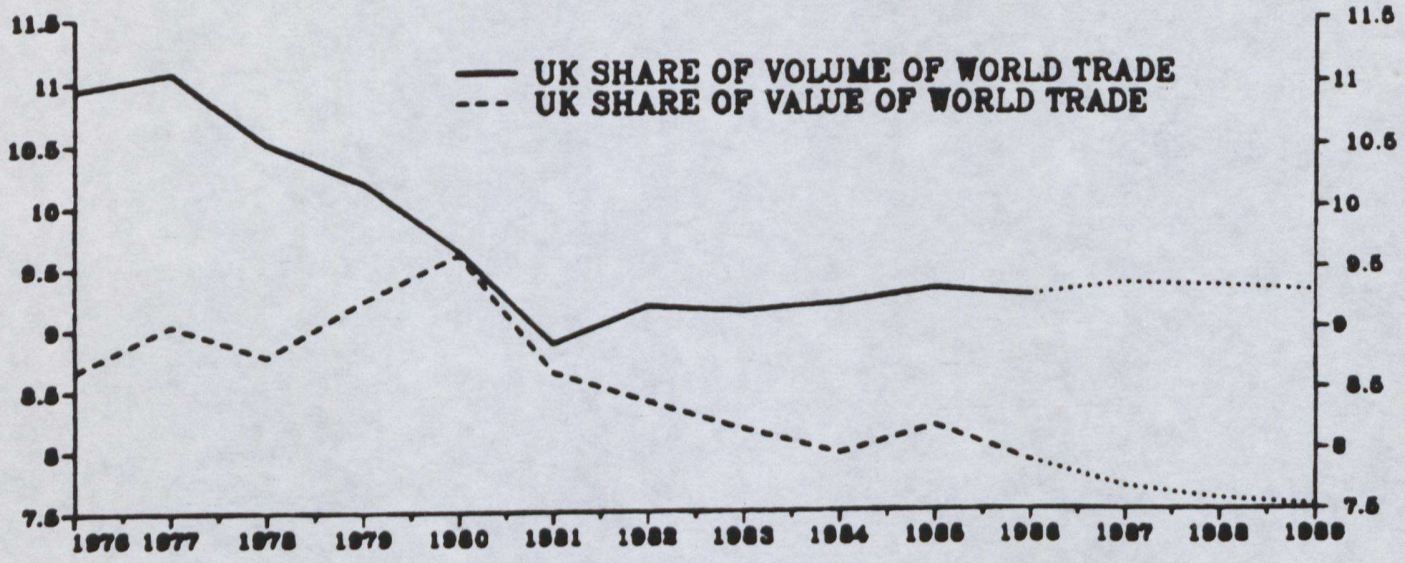


Trade in Goods

71. There are still major uncertainties about the rate at which world trade has been growing this year, and hence it is not possible to allocate with any confidence the responsibility for the weakness in UK manufactured exports as between weak markets and poor trading performance. On the WEP's assessment of world trade growth, however, with only 2 per cent growth in UK markets in 1986 the flat performance of UK exports, following on two exceptionally good years, does not appear too bad.

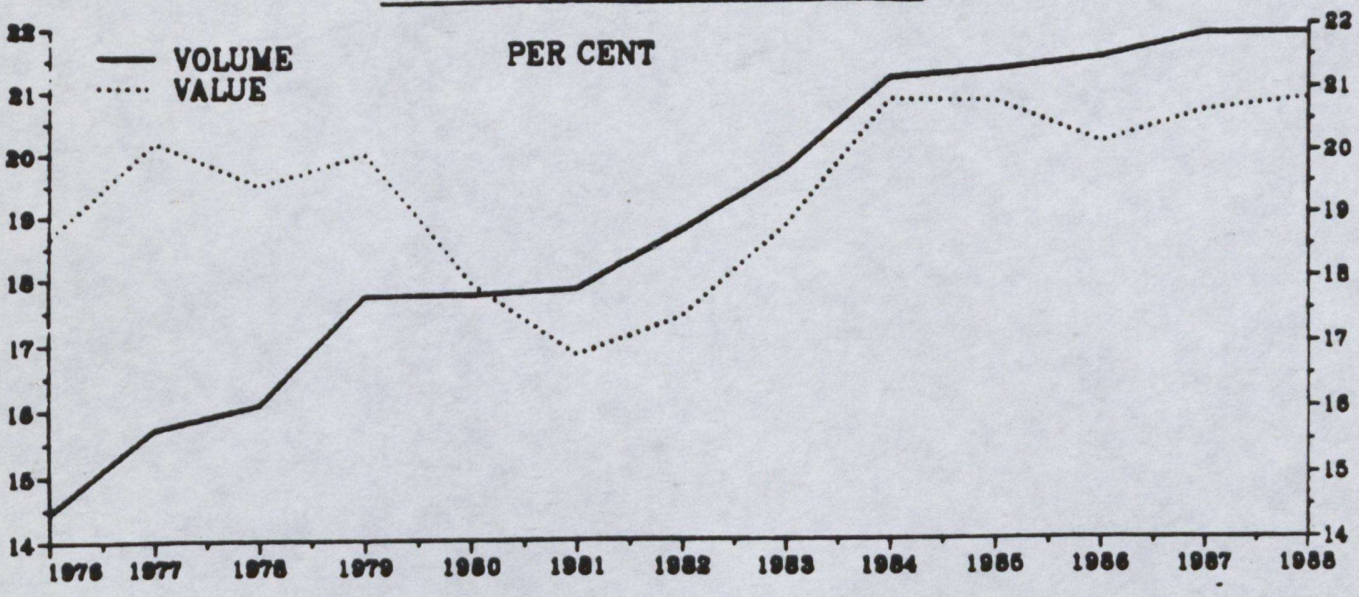
72. Although exports have recovered since the first quarter, neither surveys of exporters nor the state of engineering export order books suggest much buoyancy in exports over the immediate future. But exports of manufactures should move ahead quite strongly in 1987, as the current recovery in demand in Europe boosts world trade and UK exporters take advantage of the recent fall in sterling. In 1988 growth in exports of manufactures is close to the growth of world trade.

U.K. SHARE OF WORLD TRADE IN MANUFACTURES



73. Imports of manufactures have also picked up sharply in recent months and the forecast for domestic demand points to quite strong growth in imports over the next two years, in spite of the improved competitive position of domestic producers. The UK has a tradition of sucking in imports at a very high rate wherever domestic demand (and particularly consumers' expenditure) is strong. For example, in 1983, during the last consumer boom, imports of finished manufactures rose by almost 14 per cent. Even the high August figures have not quite brought imports back to this sort of rate of increase: in the three months to August imports of finished manufactures were about 9 per cent up on a year earlier, having been no higher than the previous year in the first half of 1986.

SHARE OF IMPORTS OF GOODS (EXCLUDING OIL) IN DOMESTIC DEMAND



TERMS OF TRADE IN MANUFACTURES

74. The terms of trade in manufactures have been relatively strong so far in 1986. Even with a sharp decline in the fourth quarter there is likely to be an improvement in the terms of trade of about 2 per cent as compared with 1985. Most of this gain is lost by the beginning of next year.

TABLE F3 : TRADE IN MANUFACTURES

(per cent change on previous year)

	Export markets	Export Volumes	Domestic Demand for manufactures (volume)	Import Volume	Terms of Trade
1985	4.6	6.1	2.6	4.9	1.1
1986	2.2	0.9	1.5	4.5	1.8
1987	4.3	5.7	4.6	7.0	-1.7
1988	4.7	4.4	3.9	4.1	-0.6

Terms of Trade in Non-manufactures and total goods

75. Table F4 shows that the non-manufactures terms of trade improved sharply in 1986 as non-food primary commodity prices (more important in UK imports than in exports) weakened. The forecast recovery in these prices means that the non manufactures terms of trade weakens in 1987 and later years. In spite of the loss of terms of trade in both manufactures and non manufactures, the terms of trade for all goods

improves slightly over the forecast period as composition of exports shifts away from (relatively low priced) oil.

TABLE F4 : TERMS OF TRADE* (1980=100)

	Manufactures	Non Manufactures	All goods
1985	102.4	99.3	100.4
1986	102.5	103.1	94.6
1987	101.3	102.8	94.6
1988	100.5	100.7	94.6

* Average Value Terms of Trade

Invisibles

76. Table F5 shows that exports of services performed very strongly in 1985: the 9 per cent overall rise in services volumes included a 14 per cent rise in civil aviation and an 11 per cent rise in travel and financial and other services exports. However, services exports are estimated to have fallen back in the first half of 1986. As in the case of manufactures exports, weakness of LDC and OPEC markets will have played a part in this decline. In the second quarter another important factor has been the decline in American tourists: tourists from America accounted for over 5 per cent by value of UK services exports in 1985, and the number of US tourists fell by about 40 per cent in the second quarter of this year compared with a year earlier.

TABLE F5 : TRADE IN SERVICES

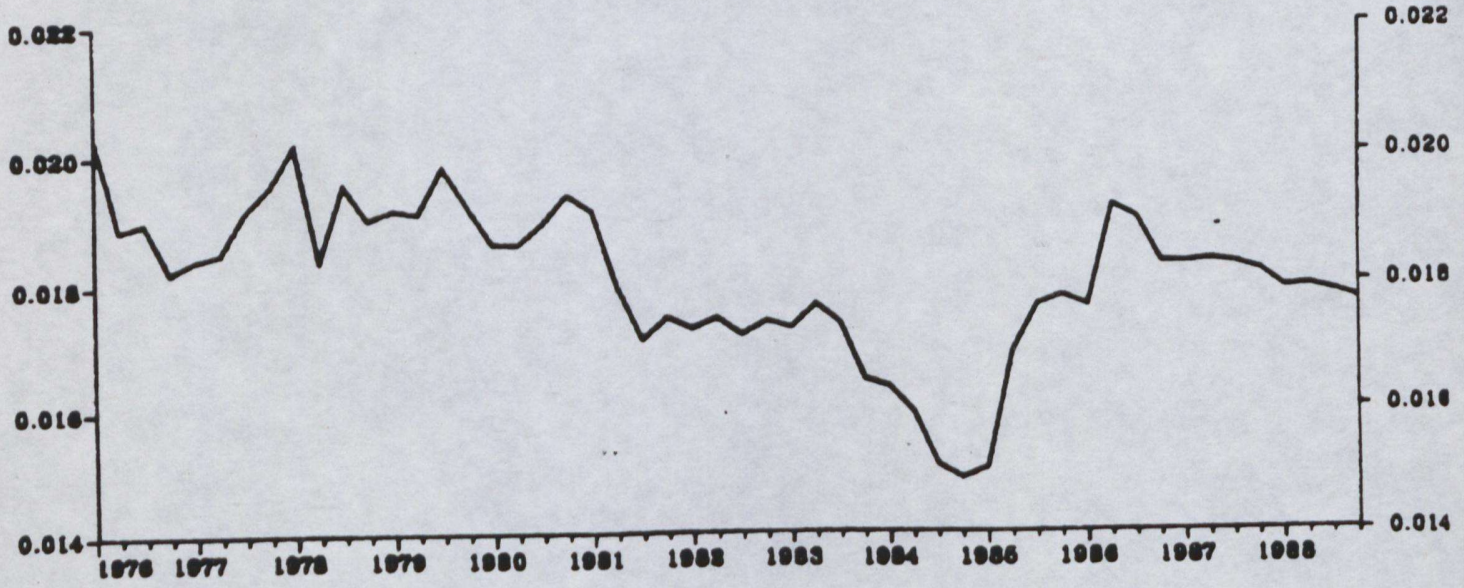
(per cent change on previous year)

	Exports	Imports	Terms of Trade
1985	9.0	1.9	1.5
1986	-2.3	5.0	3.6
1987	3.5	3.1	-3.1
1988	4.0	2.8	-2.2

77. The effect of fears of terrorism on US tourism will no doubt start to wear off, but it appears that bookings still remain relatively depressed and we have allowed for only a modest recovery in the second half of this year. Thereafter tourism and some other services exports should benefit from the lower level of sterling against European currencies. But demand from OPEC will continue to fall and demand from

other LDCs will recover only slowly. The chart below shows that services exports are forecast to hold up well relative to the value of world trade.

EXPORTS OF SERVICES OVER WORLD TRADE IN CURRENT PRICES



78. Imports of services (particularly UK tourism overseas) have picked up this year. The forecast has a near constant value share of imports in total final expenditure. The balance of trade in services at current prices improves by £½ billion a year on average between 1986 and 1989.

79. Earnings from interest, profits and dividends (IPD) should rise strongly in the second half of 1986: the first half has already seen a large (£1.6 bn at annual rate) fall in debits to oil companies, but this has so far been offset by special factors (write-offs and stock losses) which have affected credits. Earnings on UK net assets will rise further next year in sterling terms because of the fall in the exchange rate. The table below shows the contribution of IPD to the current account over the forecast period.

TABLE F6 : IPD BALANCE

(£ billion)

	Oil	Non-oil	Total
1985	-1.7	5.1	3.4
1986	-0.7	6.3	5.6
1987	0	6.8	6.8
1988	0.2	7.1	7.3

G : INFLATION

80. The general outlook for inflation over the next year or so remains much as it was at the time of the last report in June. However, as a result of changes to the prospects for interest rates, the RPI in 1986(4) is now likely to be higher than forecast in June: some $2\frac{3}{4}$ per cent above its 1985(4) level. In 1987 Q4, the RPI is likely to be just over 4 per cent above its 1986(4) level. The outlook for interest rates is an important factor in the pick up in RPI inflation next year. A combination of exchange rate depreciation and a recovery in world commodity prices in 1987 and 1988 means that inflation is expected to rise further in 1988. UK inflation is expected to remain high by the standards of the other major industrial countries reflecting higher growth in wage costs and a forecast decline in the exchange rate.

TABLE G1 : SUMMARY OF INFLATION PROSPECTS

	1985	1986	1987	1988
Consumer (retail) prices				
UK	6.1	3.2	4.1	4.3
G7 less UK	3.8	1.6	1.8	2.7
Producer (Wholesale) Output prices				
UK	6.3	4.2	3.4	5.2
G7 less UK	1.8	-3.5	0.1	2.8
Actual Average Earnings				
UK	7.7	7.3	7.3	6.7
G7 less UK	5.0	3.5	3.6	4.2

Producer Prices

81. The rate of growth of producer prices has fallen in 1986 with the fall in oil prices and other input prices. The four quarter rate of increase is expected to continue to fall, reaching a low of 3 per cent in 1987(3). Profit margins may fall back a little from the high levels experienced in 1986 when the decline in input prices has not been fully passed on. It appears that manufacturers have been able to raise margins substantially this year in spite of the small rise in the prices of competing imported manufactures.

TABLE G2 : MANUFACTURING COSTS AND PRICES

percentage change on a year earlier

	Unit Labour Costs	Cost of Materials and Fuels	Estimated Total Costs	Domestic Producer Output Prices	Prices of Imported Manufactures
1985	4.9	4.2	4.7	6.3	5.8
1986	5.7	-11.6	0.5	4.2	1.9
1987	2.7	2.7	3.5	3.4	6.9
1988	4.0	5.2	4.4	5.1	5.8

Nationalised Industry Prices

82. The June forecast had anticipated the cuts in domestic electricity prices now announced for the fourth quarter of 1986. The prospects for 1987 are for low price increases overall as the energy industries continue to pass on the benefits of lower oil prices. The picture would be changed a little by excluding British Gas prices from the Nationalised Industries total. British Gas has a high weight in the NI price index and fairly large price falls are anticipated for gas in 1987 and 1988.

TABLE G3 : NATIONALISED INDUSTRY PRICES

percentage increases on a year earlier

	Inc BGC	ex BGC
1986 Q4	2.9	2.9
1987 Q4	1.5	3.3
1988 Q4	3.8	4.4

Food Prices at the end of the year are expected to have increased by

about 3¼ per cent compared with the end of 1985. With UK weighted world food prices in sterling expected to rise by less than 4 per cent through 1987, the rate of increase of the Food RPI is expected to be around 3 per cent in 1987.

Housing Prices

83. The forecast for housing prices has changed since June. Table G4 shows shows successive forecasts of the mortgage rate since the FSBR.

TABLE G4 : MORTGAGE INTEREST RATES

	Current Forecast	June 1986 Forecast	FSBR Forecast
1986 Q4	11.00	10.00	11.75
1987 Q4	12.25	10.50	11.00
1988 Q4	12.25		9.70

84. A change of 1 point in the mortgage rate changes the RPI by very nearly ½ percent. Thus the upward revision to interest rates since the June forecast wholly explains the upward revision to the inflation forecast for 1986(4) from 2¼ to 2 3/4 percent. The downward revision to interest rates since the FSBR explains about half the change in the inflation forecast from 3½ to 2 3/4 percent.

Other prices

85. Petrol prices have risen to about 169p per gallon and little change is expected for the rest of the year. Sterling oil prices are, on the current assumption, expected to rise in line with the decline of sterling, and retail petrol prices are expected to rise by only about 6p per gallon (about 3 per cent) by the end of 1987.

86. In the remaining part of the RPI - about 55 per cent of the total index which includes Durable Household Goods, Footwear and Clothing, Services, etc - recent monthly increases have been quite small and the twelve month rate of inflation has declined from around 5½ percent in December 1985 to about 4 percent in August: given the weakness, recent and prospective, in wholesale prices the forecast is for this decline to continue until the end of 1987. "Other prices" have in the past followed producers output prices fairly closely as the chart below shows, and this is likely to continue.

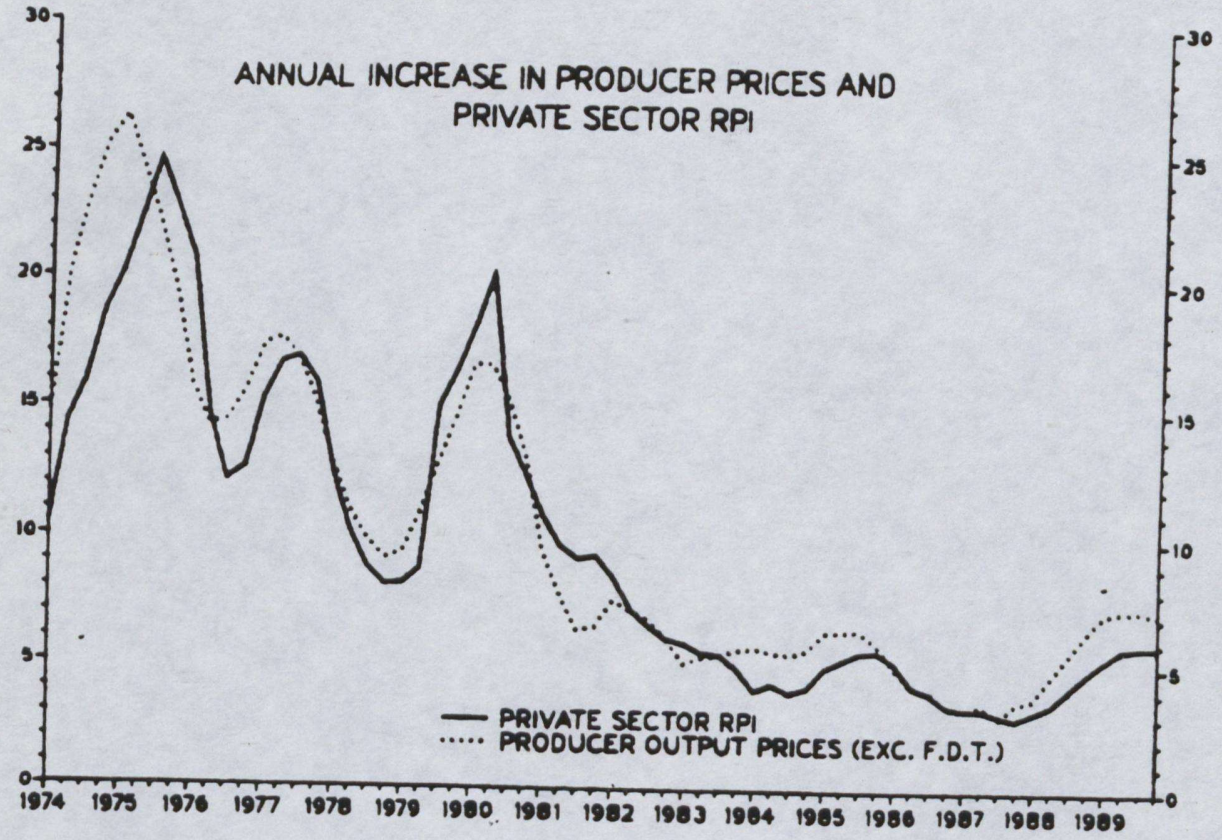


TABLE G5 : THE RPI

(Per cent change on a year earlier:
FSBR forecast in brackets)

	1986 Q4	1987 Q4	1988 Q4
Food prices	3.3(3.0)	2.4(2.9)	3.5
NI prices	2.9(3.8)	1.5(1.7)	3.8
Housing Prices	4.5(7.4)	12.5(4.2)	7.9
"Other prices"	2.2(2.8)	3.0(4.0)	4.8
- of which Petrol	-12.1(-10.6)	3.3(3.1)	4.5
- Other items	3.5 (4.0)	3.0(3.4)	4.8
All items RPI	2.8(3.6)	4.1(3.3)	5.0
RPI excluding mortgage interest payments	[3.2]	[3.2]	[4.7]

Table G5 shows the current forecast.

87. The recent monthly figures of RPI inflation of 2.4 percent in both July and August are expected to be lower than any in the forecast

period. The expected monthly path of RPI inflation is shown in Table G6:

TABLE G6 : MONTHLY PATH FOR THE RPI

	RPI	RPI(1) ex MIP		RPI	RPI ex MIP		RPI	RPI ex MIP
1986 J			1987 J	3.4	3.2	1988 J	3.8	3.5
F			F	3.3	3.1	F	3.7	3.3
M			M	3.6	3.4	M	3.5	3.1
A			A	4.1	3.7			
M			M	4.2	3.7			
J			J	4.6	3.7			
J			J	4.7	3.8			
A			A	4.6	3.7			
S	2.9	3.3	S	4.4	3.5			
O	2.8	3.2	O	4.1	3.2			
N	2.8	3.2	N	4.1	3.1			
D	2.8	3.2	D	4.2	3.2			

(1) RPI excluding mortgage interest payment

GDP deflator

88. The GDP deflator measures the price of UK "value added". As such it is a good but not infallible indicator of trends in domestically generated inflation. In 1986, however, its rate of growth will be affected by the decline in oil companies profits. Table G7 compares recent forecasts.

TABLE G7 : FORECASTS OF THE GDP DEFLATOR

	1984-85	1985-86	1986-87	1987-88	1988-89
MTFS	4.2	6.1	3.7	3.8	
June Forecast: total	4.3	6.2	3.1	3.9	
non-oil	3.5	8.1	5.6	3.4	
Autumn Forecast: total	4.2	6.1	2.9	4.1	4.9
non-oil	3.6	7.9	5.5	3.7	4.6

Earnings

89. The outturn for the 1985-86 pay round which has more or less finished shows the average level of settlements in the private sector at 5 3/4 percent, a little lower than last year. Settlements in the public sector were 6½ percent. Underlying average earnings growth for the whole economy is expected to have been 7½ per cent.

90. The 1986-87 pay round has not got off to a good start, with the LA manuals' probable settlement at 6.7 percent, the usual Police settlement at 7.5 percent and the widespread recognition that the teachers restructuring agreements will result in very large pay rises. Too few settlements in the private sector have occurred to permit any firm conclusions to be drawn yet about the likely average rate for the round. Private sector sources have been widely reported as saying that settlements so far have been mainly in the 5 percent to 7 percent range and that 5 percent may provide a barrier. With the fall in inflation from about 6 percent at this time last year to around 3 percent now, we have forecast a reduction in the average level of private sector settlements from 5 3/4 percent to 5 percent. Table G8 below shows factors which might be expected to affect settlements. With little change expected in unemployment and with profits continuing to improve, there is little likelihood of a marked drop in the average level of settlements.

TABLE G8 : FACTORS INFLUENCING PRIVATE SECTOR EARNINGS' PAY ROUNDS

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
RPI inflation			(figures in brackets are forecast)				
(i) At start of round, Q3	8.0	4.6	4.7	6.3	(2.5)	(4.6)	(4.5)
(ii) Outcome on inflation, Q3	4.6	4.7	6.3	(2.5)	(4.6)	(4.5)	(5.8)
Unemployment Rate Level at start of round	10.1	10.9	11.1	11.3	(11.6)	(11.4)	(10.3)
Real take home pay (per cent, second half year on second half	1.6	4.1	1.4	3.5	(5.0)	(3.3)	(4.8)
Profit Share per cent (Non North Sea ICCs)	6.9	7.7	8.9	10.5	(11.4)	(12.4)	(12.0)
Underlying Earnings Growth per cent change on a year earlier	8.3	7.8	8.5	7.5	7.2	6.8	6.8

91. So far this year the decline in overtime working compared with 1985 has been holding the growth of average earnings down. Output of manufactures is expected to grow at an annual rate of 3½ percent in 1986 H2 and 4 per cent in 1987. This is likely to be accompanied by higher overtime working which means that wage drift will be higher in the 1986-87 round than in the 1985-86 round. In the 1987-88 pay round earnings growth may slow slightly following further large gains in real take home pay; but, with no further slowdown in RPI inflation, there is little reason to expect any further deceleration in earnings growth in the 1988-89 pay round.

92. In the public services sector settlements were a good deal higher in the 1985-86 pay round than in the private sector, but not by enough to permit average earnings growth to exceed that in the private sector, so that the public services' relative position worsened slightly. The example of the teachers and of LA employees - both manual and white collar - can only encourage those other public services groups which have fared relatively badly in recent years (broadly speaking those not covered by Review Bodies). The forecast assumes that public service pay grows in line with private sector pay, except for an allowance made for the faster growth of teachers' pay.

TABLE G9 : UNDERLYING EARNINGS GROWTH BY PAY ROUND AND SECTOR

	Private Sector		Public	Public
	Total	Manufacturing	Services	Trading
1984-85	8½	9½	5½	7½
1985-86	7½	7½	7½	8 3/4
1986-87(f)	7½	73/4	8½	7½
1987-88(f)	6 3/4	7½	6 3/4	6 3/4
1988-89(f)	6 3/4	7½	7½	6 3/4

f = forecast

H : PERSONAL AND COMPANY INCOME AND SPENDING

(1) The personal sector

Consumer expenditure and saving

93 During 1986 the strength of consumers' expenditure has been even greater than the buoyancy of personal incomes would have suggested. Normally when after tax personal real incomes accelerate the saving ratio rises; but, after reaching its lowest level for 13 years in 1985, the saving ratio has fallen again so far this year, and in 1986 as a whole may be some ½ a percentage point lower than last year.

94 The fall in the personal sector saving ratio during the 1980s can be attributed to the reduction in inflation. With lower inflation past savings are eroded less rapidly, and in order to maintain a given level of real savings there is less need to save to offset inflation losses. If, as in Table H1, the measured saving ratio is adjusted for this - by deducting from saving that part required to offset inflation-induced losses on financial assets - a more stable measure of the personal sector saving ratio is produced:

TABLE H1 : PERSONAL SECTOR SAVING

	Personal saving ratio	Adjusted saving ratio
1980	15.1	7.9
1981	13.4	6.2
1982	12.8	7.5
1983	11.5	7.7
1984	11.7	8.9
1985	11.1	8.2
1986	10.5	7.8
1987	10.6	8.3
1988	10.7	8.4
1989	10.2	7.3

95. The forecast has the following annual fiscal adjustments.

1987	£2.4bn
1988	£5.6bn

These cuts in income tax mean large increases in real personal disposable income over the next few years. Thus even with a fairly flat personal saving ratio from now on, there is strong growth in consumers' spending, particularly on durables.

TABLE H2 : CONSUMER SPENDING,
(per cent change on year earlier)

	Non durables	Durables	Total
1985	3.0	7.4	3.5
1986	4.1	8.5	4.6
1987	3.4	6.6	3.8
1988	3.4	8.0	4.0

The Housing Market

96. The buoyancy of personal incomes is an important factor behind the strong growth of house prices since mid 1985. Net mortgage advances are now running at high levels, but the major part of the increases in these advances seems to have come after the acceleration in house prices got underway. It was in part the pick up in prices and the expectations of further price rises that created the conditions which enabled the lending institutions to increase their business.

97. Although private housing starts have been rising since early 1985, completions have so far lagged well behind and persons' investment in new dwellings did not start to rise until the spring of 1986. Because of the lag (of roughly 1½ years) between starts and completions, the rise in private starts (about 10 per cent up on a year earlier in the first half of 1986) should ensure that this component of investment will record strong growth in 1987. Expenditure on improvements to existing dwellings - which counts as part of personal sector housing investment - should also continue to reflect the general buoyancy of personal spending.

Personal sector: summary

98. Table H3 summarises the forecast for personal income and spending.

TABLE H3 : PERSONAL INCOME AND SPENDING
(per cent changes on a year earlier)

	RPDI	Consumers' expenditure	Investment in new dwellings	Total housing investment	Persons' net acquisitions of financial assets (£bn)
1985	2.8	3.5	-13.1	-2.0	10.1
1986	3.9	4.6	7.4	6.5	8.7
1987	3.9	3.8	4.2	6.2	8.1
1988	4.1	4.0	0.9	4.0	8.0

(2) : Company income and spending

Profits

99. Industrial and commercial companies' (ICCs) profits net of stock appreciation are estimated to have been some £2 billion (7 per cent) lower in the first half of 1986 than a year earlier. A £5½ billion decline in North Sea oil companies profits more than accounts for this fall. Other ICCs have seen a further improvement in profitability over the last year as falling oil and other material prices have kept down their total costs in spite of the slowdown of productivity growth.

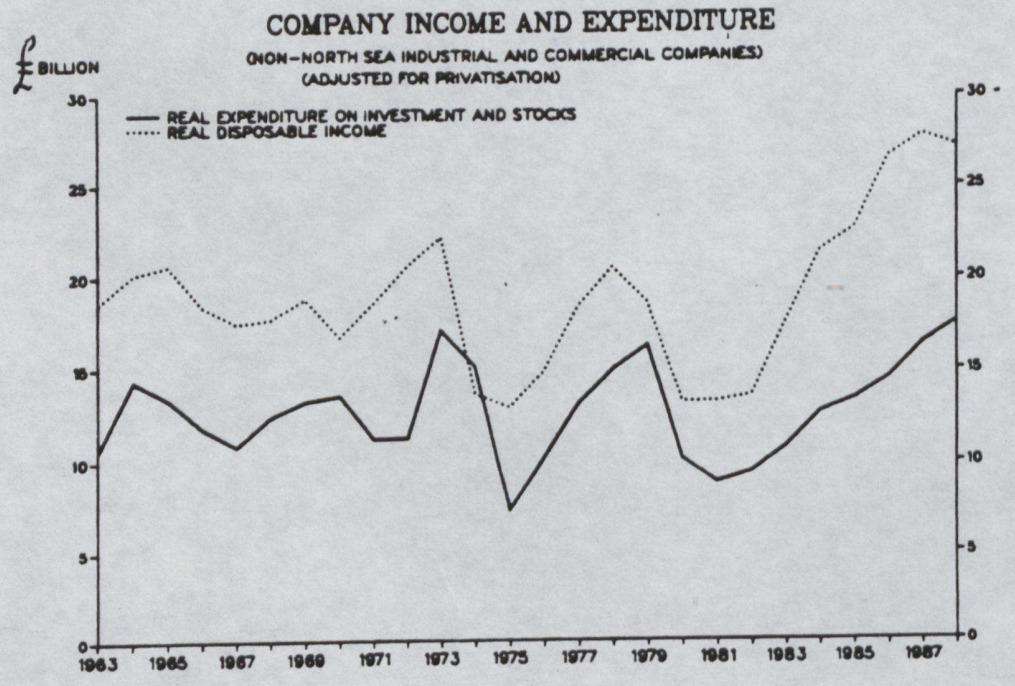
TABLE H4 : INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits* as a share of Total Income (%)		Rate of return (%) on assets, non-North Sea*
	Oil	Non-oil	
1973-1983 average	2.5	10.5	5.4
1984	6.8	11.1	6.5
1985	6.0	12.3	7.5
1986	2.5	13.5	8.4
1987	2.2	13.9	8.8
1988	2.0	13.4	8.2

*Net of stock appreciation and adjusted for privatisation.

100. Over the forecast period the growth of non-oil company disposable income flattens off as companies' rate of return stabilises and

corporate taxes catch up with the growth in profits (and the number of tax exhausted companies declines). So far in 1986 company spending has been relatively weak. The process of adjustment to changes in taxation and allowances announced in 1984 and also high real interest rates have depressed both stockbuilding and fixed investment. Spending should rise a little more strongly as stockbuilding picks up somewhat, but the persistence of high interest rates means that spending remains at a relatively low level in relation to companies' disposable income.



Business Investment

101. Large quarter to quarter fluctuations over the last two years have made it difficult to be confident about the underlying trend in fixed investment. it has been particularly difficult to assess how much business finance lessors would do once the completion of the changes announced in 1984 had removed most of their raison d'etre. The figures for 1986Q2 showed a fall back in fixed investment, and in particular in finance lessors' activities, roughly on the scale anticipated in the June forecast. It is likely that for 1986 as a whole <u>non-manufacturing investment</u> will rise at around the rate shown in the DTI Intentions Survey published at the beginning of June. Figures for the first half of the year and the results of the most recent CBI enquiry suggest that <u>manufacturing investment</u> (including leasing) may rise by a little less

than the June DTI Survey had indicated.

102. In 1987, given the fairly buoyant prospects for output, non-oil business investment is likely to rise by slightly more than the (unpublished) estimates in the June DTI Intentions Survey. Table H5 shows the forecasts, together with the June DTI Survey figures for 1986 and 1987.

TABLE H5 : FIXED INVESTMENT
(percentage change on previous year)

	1986	1987	1988
Manufacturing*			
June DTI Survey	3	2	-
HMT Autumn Forecast	1	5	6
Non-oil, non-manufacturing**			
June DTI Survey	4	5	-
HMT Forecast	4	4	6

* Including leased assets

**Adjusted for privatisation and excluding assets leased to manufacturers.

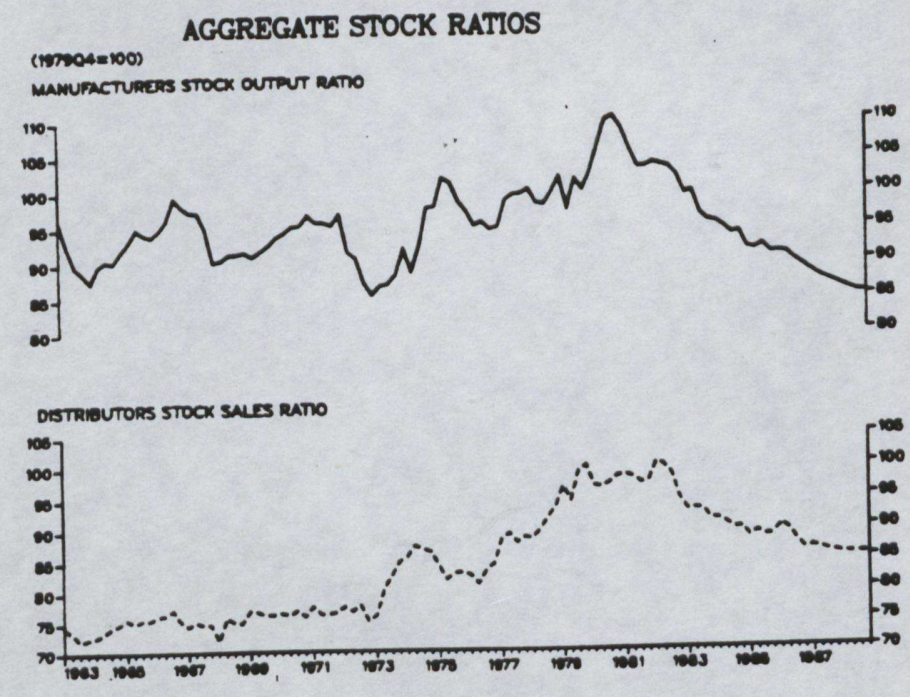
103. Table H6 compares the latest forecast for total fixed investment with that published in the FSBR. The overall shortfall of fixed investment this year relative to the FSBR forecast is attributable in large part to a much faster cut back of spending in the North Sea than originally expected by the Department of Energy.

TABLE H6 : FIXED INVESTMENT
(percentage change on year earlier:
figures in brackets were 1986 FSBR forecasts)

	£ billion at 1980 prices 1985	1985	1986	1987
Business Investment	30.4	4(2)	1(5)	2
Residential Investment	9.4	-1(0)	3(5)	6
General Government Investment	6.6	-4(-5)	4(2)	-2
Total fixed investment	46.3	2(1)	2(5)	2

Stockbuilding

104. The weakness of manufacturing output over the last year does not appear to have led to any significant involuntary build up of stocks: indeed, the manufacturing stock output ratio has fallen further compared with a year ago. The sharp rise in retail sales has led to a renewed fall in the ratio of stocks to sales in distribution. Surveys suggest that both manufactures and distributors would like to reduce stock ratios further. The forecast shows that stock holdings will in aggregate start to stabilise relative to output in 1987-88 - the implied recovery of stockbuilding to levels that are more sustainable in the longer term makes a significant positive contribution to growth in total domestic demand over the forecast period.



I: PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

105. Unemployment (UK, seasonally adjusted excluding school leavers) rose by 97, 000 in the year to August, with most of the increase being recorded between December 1985 and March 1986. Although the sudden deterioration in the unemployment trend at the end of last year was a surprise at the time, in retrospect it is explicable in terms of the flatness of the economy during 1985.

106. The total increase in unemployment over the last year was slightly less than in the two previous years, while growth in employment has slowed down substantially: from over 450,000 in the year to June 1984, to under 350,000 the following year, and to probably around 200,000 in mid 1986. Even with this deceleration in employment, estimated growth in the sum of those in employment and the unemployed claiming benefit has probably exceeded by more than 100,000 the Department of Employment's most recent (July 1985) projection of labour force growth for mid 1985 to mid 1986. It is likely that growth in the population of working age has again been larger than expected, and a significant proportion of new jobs may still be going to previously unemployed women who had not been claiming benefit. However, any rise in female activity rates that may have occurred over the last year will have been on a much smaller scale than that experienced in 1984.

107. Productivity growth in the non-oil economy slowed down in the year to 1986(2) to below 1½ per cent, after four years in which it had averaged 2 3/4 per cent. The slowdown over the last year is probably the result of the slowdown in output. Indeed if anything employment growth has been weaker over the last year than would have been expected given the path of output.

108. The labour market forecast is dominated by the strong output growth forecast for the non-oil economy. Non-oil output is forecast to grow at a rate close to 3½ per cent over the next 2 years. Although this is below the growth rate experienced between mid 1983 and mid 1985 - a period when unemployment continued to rise - the forecast is for unemployment to fall by a substantial amount in total over the next three years. The main reasons are:

(i) lower growth in population of working age;

(ii) a more sustained recovery of manufacturing output;

(iii) less of a rise in female activity rates - the 1½ point rise in female activity rates in 1984 is without recent precedent.

109. Given the output path the forecast for unemployment depends on the forecasts for productivity growth, for growth in population of working age, and by the forecast for activity rates.

110. Productivity growth is not likely to return to the peak rates experienced in the early stages of the upswing that started in 1981. Even though the economy may again be moving from a downswing to an upswing phase, recent cyclical movements have been very damped compared with the experience of 1980 and 1981, and cyclical effects on productivity will be correspondingly less. Table I1 shows the forecast for productivity in the non-oil economy before and after allowing for cyclical influences.

TABLE I1: PRODUCTIVITY GROWTH, per cent per annum

	Manufacturing		**Non-manufacturing**		
	Trend	**Actual**	**Trend full-time worker**	**Trend per head**	**Actual**
1973-79	1.5	0.7	1.4	0.9	0.6
1979-86	2.8	3.1	1.4	0.6	1.3
1986-88	3.0	4.1	3.3	2.5	1.4

111. The non-manufacturing productivity forecast allows for exceptional productivity gains in some nationalised industries between 1985 and 1988 (particularly in British Coal, but also in British Rail and the Post Office). Against this some selective employment measures, the 1985 restructuring of NICs, and a continuing trend towards part-time employment tend to reduce growth in output per head.

112. Earlier official projections of population of working age proved too low for both 1984 and 1985. Between mid 1984 and mid 1985 the population of working age grew by 77,000 more than had been forecast by OPCS: emigration was lower than expected (immigration was much as expected). The reduced attractions of South Africa as a destination for emigrees, and high unemployment in some other potential destinations, will probably mean lower net emigration over the next few years than has been assumed in the past by OPCS.

113. The forecast allows for a rise in female activity rates above those assumed by Department of Employment: the strong forecast growth in demand for labour is likely to mean that employers will find ways of inducing women into the labour force on a scale not allowed for in the official labour supply projections. It is also likely that some of the new jobs created over the next few years will go to unemployed women currently recorded as looking for jobs (ie in the labour force), but not claiming benefit: thus the "working population" (employed plus claimant unemployed) will rise faster than the labour force (employed plus unemployed actively looking for work). Table I2 compares the present forecast for labour supply and working population with the Department of Employment's most recent projections.

TABLE I2: PROJECTIONS OF LABOUR SUPPLY AND WORKING POPULATION (000's)

Mid Year Changes	Labour Supply: July 1985 Employment Gazette (GB)	Labour Supply: Treasury Forecast (UK)	Working Population: Treasury Forecast (UK)***
1984 to 1985	192*	200*	489*
1985 to 1986	179	276	293**
1986 to 1987	160	247	306
1987 to 1988	103	174	211

* Outturn

** Estimated outturn

*** Adjusted for classification changes

114. The forecast is for unemployment to stabilise over the latter part of 1986 and early 1987, helped by the initial impact of the Restart programme. Thereafter the combination of faster growth in ouput and slower growth in labour supply means that unemployment is forecast to fall sharply, even though little further effect of SEMS is allowed for after mid 1987.

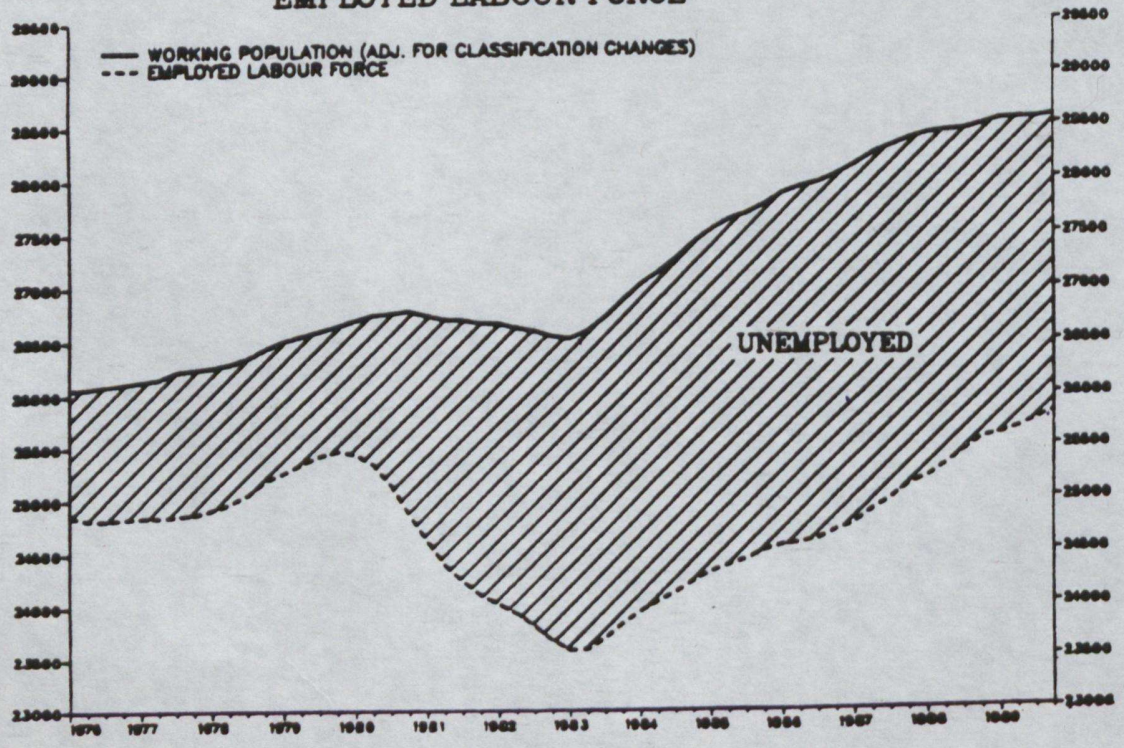
TABLE I3: ADULT UNEMPLOYMENT (seasonally adjusted 000'S, changes)

		of which, effect of:	
	Unemployment	SEMS*	Restructuring of NICs
1984(2)to 1985(2)	+ 146	+ 1	0
1985(2)to 1986(2)	+ 89	- 73	- 10
1986(2)to 1987(2)	+ 33	- 130	- 28
1987(2)to 1988(2)	- 195	- 15	- 14

* Including Restart effects

115. The chart below illustrates the contribution of higher employment growth and slower growth in working population to the forecast decline in unemployment.

WORKING POPULATION AND EMPLOYED LABOUR FORCE



J: AGGREGATE DEMAND AND ACTIVITY

116. This forecast is characterised by strong growth in private sector expenditure and in particular by a continuation through to 1988 of the current consumer boom. The strength of private expenditure reflects among other things:

(i) relatively slow growth of public spending, which permits annual reductions in taxation;

(ii) fiscal relaxation at the start of the period, a large increase in the General Government financial deficit in 1986-87 (after the undershoot in 1985-86);

(iii) a near stabilisation of stock output ratios, which have been falling so far throughout the 1980s.

117. Manufactured exports are forecast to grow quite strongly in 1987 and 1988 as the effects of the gain in competitiveness during 1986 comes through and as world trade growth recovers from the weak performance this year. However North Sea output is expected to decline from 1987 and the fall in oil exports drags down total export growth. The strength of domestic demand means that import growth will be quite buoyant, and GDP grows less fast than domestic demand.

	Composition of Expenditure			
	1985	**1986**	**1987**	**1988**
Personal consumption	3.5	4.6	3.8	4.0
Public consumption	0.4	1.6	1.3	0.9
Total investment	1.8	2.0	2.2	2.8
Change in stockbuilding (as per cent of GDP)	0.3	- 0.1	0.6	0.2
Total domestic demand	2.8	3.4	3.5	3.3
Exports of goods and services	6.2	0.9	2.9	2.9
Imports of goods and services	3.0	4.1	4.6	3.9
GDP (Average measure)	3.6	2.3	2.9	3.0

118. The table below shows the path of GDP before and after allowing for the coal strike, and also non-oil GDP. Manufacturing output will benefit from the recovery in manufactured exports over the next two years, and is forecast to grow slightly faster than non-oil GDP in those years.

GDP Measures, 1980 = 100 and per cent changes on a year earlier

	1985	1986	1987	1988
GDP Average Measure	110.5 (3.6)	113.0 (2.3)	116.3 (2.9)	119.7 (3.0)
Contribution of North Sea production to GDP changes	- 0.1	0	- 0.5	- 0.6
Effects of coal strike	+ 0.8	+ 0.4	-	-
GDP less contribution of oil and coal strike	2.8	1.8	3.4	3.6
Manufacturing output	3.1	0	3.9	4.3

ANNEX A:

PUBLIC EXPENDITURE ASSUMPTIONS

8. The starting point for the public expenditure forecast were the plans in the 1986 PEWP, as amended in the Budget (for the employment measures). To these programme plans (excluding the Reserve) were added:-

a. estimating changes, including more realistic levels of local authority spending and also taking account of the effects, on social security expenditure for example, of different economic assumptions (inflation, unemployment, interest rates, etc) from those underlying the 1986 PEWP plans;

b. allowance in all years for other ("discretionary") allocations from the Reserve during the year where past experience showed that upward pressures were likely.

9. Further assumptions made were as follows:-

i. On average, public sector earnings are assumed to rise at about the same rate as in the private sector, from 1986-87 onwards, except for an addition to the teachers' pay bill, resulting from the Coventry agreement. A similar agreement is assumed to be reached for Scottish teachers,

ii. Central government manpower is assumed unchanged, except for Civil Service manpower, which will fall broadly in line with targets, and health service manpower, where a small rise after 1987-88 is assumed. However, local authorities' manpower has recently begun to grow again; It is assumed that LA manpower increases at around ½ per cent per annum, in terms of full-time equivalents, over the forecast period.

iii. Cash limits on central government expenditure will not be breached for 1986-87, except for discretionary additions from the Reserve. For 1987-88 and 1988-89 the forecast of cash-limited expenditure plans derives from the earnings and employment assumptions and a realistic projection of procurement volumes.

iv. The forecast assumes that the level of (Aggregate Exchequer) grant for local authorities in 1987-88 is based on plans now agreed, except for some additional grant in respect of the teachers' pay deals. Because the forecast implies that spending plans will be exceeded, and grant penalties applied, the outturn for the level of grant as a percentage of total relevant expenditure in 1987-88 is lower than in plans. In order to forecast grant in 1988-89, it has been assumed that the outturn grant percentage will continue at the projected 1987-88 level.

v. For nationalised industries prices, forecasts of energy prices take into account the forecast level of oil prices, and the electricity/coal agreement reached earlier this year. However, some increase in electricity prices in 1987 is assumed, after virtually no (net) change in 1986. Further real increases in British Rail (passenger) and water prices are assumed in 1987-88 and 1988-89.

vii. Asset sales of £4 3/4 billion are assumed for 1986-87 and £5 billion per annum thereafter. British Gas is assumed to be sold in 1986 Q4, and British Airways in 1987 Q1.