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V/ur

Treasury Chambers, Parliament Street, SW1P 3AG
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18 January 1988

P R C Gray Esq
10 Downing Street
LONDON SW1

Dear Paul,

THE ECONOMIC SITUATION

... I attach a note by Sir Terence Burns for discussion at the Prime Minister's meeting on Wednesday, 20 January.

Yours
Allec

A C S ALLAN

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THE ECONOMIC SITUATION - JANUARY 1988

A note by the Chief Economic Adviser

All the major economies have now been expanding for five years since the recession - some, among them the UK, for rather longer. Growth weakened a little after the strong recovery of 1984, but remained in the $2\frac{1}{2}$ - $3\frac{1}{2}$ per cent range. Recent evidence suggests that activity was picking up again in 1987 particularly in the US and Japan, although it remained weak in Continental Europe. Consumer price inflation in the main industrial countries rose during 1987 as the impact of the earlier fall in the oil price diminished.

2. Growth in the main industrial countries is expected to remain buoyant in the first half of 1988. The stock market collapse may have a perceptible effect on demand in the US though there are few signs of it yet. Only weak effects are expected elsewhere.

Table 1

World Growth and Inflation
Percentage changes

	Major 7 GNP	Major 7 CPI
1983	2.8	5.0
1984	4.9	4.3
1985	3.1	3.9
1986	2.7	2.1
1987E	2.9	2.9

E: Treasury estimate

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3. The UK economy is performing well. Growth and inflation in recent years have been much the same as in the 1950s and 1960s in contrast to the major industrial countries where growth has been less and inflation no better.

Table 2

<u>UK Economic Indicators</u>				
Percentage changes				
	GDP	Retail prices index	Manufacturing Productivity	Profitability* (level)
1983	3.3	4.6	8.6	4.8
1984	2.4	5.0	5.6	5.6
1985	3.6	6.1	3.3	7.2
1986	3.0	3.4	2.8	8.9
1987E	4.2	4.1	7.2	10.4

*Net return on capital employed by non-North Sea industrial and commercial companies

E: Treasury estimate

4. There are increasing signs of a real supply side improvement - faster growth of productivity, better profitability, improved rates of return on investment and much better than expected trade (especially export) performance.

5. The Government's own accounts are in good order - for the current financial year the PSBR is likely to be negative.

6. The increase in GDP in 1988 over 1987 could be higher than the $2\frac{1}{2}$ per cent envisaged in the Autumn Statement. But the rate of growth is expected to slow down through the year following the very sharp rise in output through 1987. This would imply no further rise in the pressure of demand at home this year.

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7. Money GDP has been growing faster than envisaged in successive editions of the MTFS: most of this excess has been due to faster growth of output. Inflation has been fairly steady, averaging around 4½ per cent over the past five years, with most of the fluctuations in the RPI due to mortgage rates and oil prices. The combination of rapid growth and low inflation is further evidence of the improvement in overall economic performance and the efficacy of the Government's stance against inflation. In the past, periods of rapid growth have habitually led to a pronounced rise in inflation.

8. Commodity prices rose during 1987 and recently pay settlements have been drifting up following an earlier decline; but unit costs have grown very little because of the rapid growth of productivity. CBI surveys show no substantial rise in the proportion of firms expected to raise prices in the next few months.

Table 3

Net Debt and Net Debt Interest as a Percentage of GDP

	1983-84	1984-85	1985-86	1986-87	Latest Estimate 1987-88
Ratio of net public sector debt* to GDP, end year	46.5	46.6	44.9	42.6	38.4
Public sector net debt interest payments as a percentage of GDP	3.1	3.3	3.1	3.0	2.7

*Bank of England definition

9. Fiscal policy has been tighter than originally intended for the past two years. Even allowing for faster growth of output and for higher privatisation proceeds the PSBR has turned out below expectations. The ratio of public sector debt to national income has been falling, contributing to a declining ratio of interest

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payments to GDP unlike most other major countries where the interest burden is rising. Estimates for 1987 show a tighter fiscal stance in the UK than in any of the other G7 countries except Japan.

Table 4

General Government Financial Balances*
(as per cent of GDP/GNP)

	United States	Japan	Germany	France	United Kingdom	Italy	Canada
1979	0.5	-4.7	-2.5	-0.7	-3.3	-10.1	-2.0
1985	-3.3	-0.8	-1.1	-2.9	-2.9	-12.3	-7.0
1986	-3.5	-0.9	-1.2	-2.9	-2.6	-11.2	-5.5
1987	-2.4	-1.2	-1.7	-2.8	-1.5	-10.3	-4.4
					(-1.1)**		

*These figures do not take credit for privatisation proceeds

**Financial year 1987-88

Source: OECD Economic Outlook, except for the 1987 UK figure which is the latest Treasury estimate

10. The evidence on monetary conditions is more difficult to assess. M0 remains within the target range, though in the upper half of it. It may temporarily move outside the range in the next few months but is expected to come back in the first half of the next financial year. Measures of broad money continue to grow rapidly, reflecting the strength of bank and building society lending.

Table 5Indicators of Monetary Conditions

	M0 ¹ Growth (%)	M4 ¹ Growth (%)	Exchange Rate Index (1975=100)	Short-term Interest Rates (%)	Long-term Interest Rates (%)
1980-81	7.1	15.9	98.2	15.5	13.6
1981-82	5.3	18.1	92.3	14.2	15.0
1982-83	3.2	16.3	88.0	11.5	12.1
1983-84	6.0	13.3	83.5	9.7	10.5
1984-85	5.5	13.2	76.2	10.9	10.9
1985-86	4.3	13.6	79.0	12.1	10.4
1986-87	4.3	15.2	71.5	10.5	9.7

Latest
Observa-
tion

4.3²15.2³74.7⁴9.0⁴9.7⁵

¹Percentage change of average level outstanding during year

²12 months to December 1987, seasonally adjusted

³12 months to November 1987, not seasonally adjusted

⁴Close 15 January 1988

⁵Close 14 January 1988

11. The exchange rate has risen over the past 12 months and the sterling index is about 8 per cent higher than a year ago. Only part of this rise is due to the fall in the dollar; the £ has also risen 6 per cent against the deutschemark over the year. Net funding over the first 9 months of the year was around £7½ billion compared with a PSBR of minus £½ billion. We have thus already sterilised three-quarters of this year's foreign exchange intervention, and at the present rate of funding it should all have been sterilised by the end of the financial year.

Table 6

Expenditure, Taxation and Borrowing
(percentage of GDP)

	General Government Expenditure (excluding privatisation proceeds)	Non-North Sea Taxes plus NICs (as % of non- North Sea GDP)	Total Taxes plus NICs	PSBR
1973-74	42.6	33.1	33.2	5.8
1974-75	48.0	35.7	35.7	9.0
1975-76	48.5	36.1	36.2	9.4
1976-77	45.9	36.0	35.8	6.4
1977-78	42.6	35.0	34.7	3.6
1978-79	43.2	34.1	33.8	5.3
1979-80	43.4	35.2	35.1	4.8
1980-81	46.0	36.1	36.3	5.4
1981-82	46.5	38.9	39.3	3.3
1982-83	46.8	38.2	38.9	3.1
1983-84	45.9	37.8	38.5	3.2
1984-85	46.2	37.8	39.1	3.1
1985-86	44.5	37.0	38.5	1.6
1986-87	43.9	37.4	37.9	0.9
Latest Estimate				
1987-88	41.7	37.8	38.1	-0.7

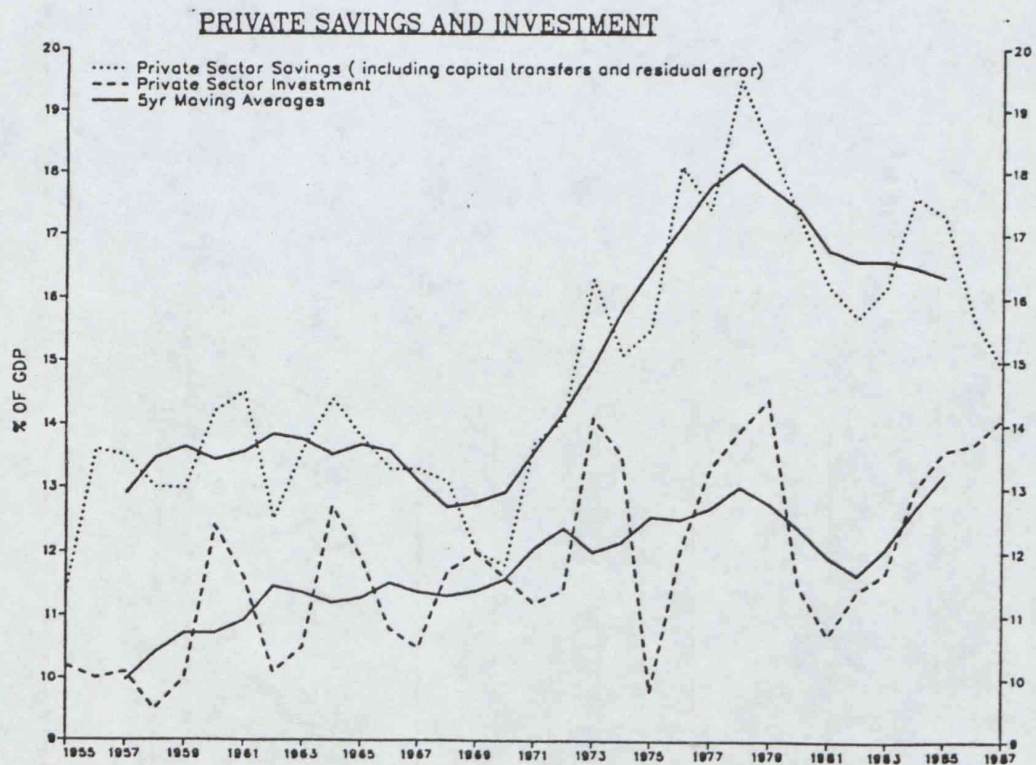
12. The ratio of public expenditure to GDP has fallen sharply since 1982-3 whether privatisation proceeds are included or excluded. The ratio of non-North Sea taxes to non-North Sea GDP fell between 1981-82 and 1985-6 but has risen over the past two years. As a result the PSBR has been falling sharply as a share of GDP.

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13. The Public Expenditure White Paper shows the public expenditure ratio continuing to fall. Inevitably there is some uncertainty about the projections for tax receipts. But with unchanged tax rates the non-North Sea tax ratio is expected to rise further.

14. Looking ahead, the fiscal position is likely to continue to be very strong, implying little or no public sector borrowing.

15. The flow of private savings is projected to be below the level of private sector investment. This is an unusual situation (see Chart). Net private sector savings have been falling as a share of GDP largely because of lower inflation and improved confidence about the economic prospect; but there may be other, temporary, factors at work. Mortgage lending growth in particular has been very rapid. Private sector investment is rising because of higher profitability, the higher levels of capacity utilisation, and some transfer of investment from the public sector (particularly housing and the privatisation programme).



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16. There may be a current account deficit of about 1 per cent of GDP. But this should not pose a problem given its size in relation to the stock of net overseas assets, the availability of world financial capital, the improved rate of return and the possibly temporary nature of the fall in private sector savings.

Issues for Discussion

- (a) Is it agreed that while world activity may continue to grow in 1988 at not much less than its recent rate, there are likely to be continued market uncertainties, particularly with respect to the dollar? Is it agreed that this points to a cautious fiscal and monetary policy in the UK?
- (b) Is it agreed that it would be undesirable to see a further rise in non-North Sea taxes as a proportion of GDP although there may not be much immediate scope for a reduction?
- (c) Is it agreed that a current account deficit does not pose a serious problem when the Government's budget is in balance and private investment is growing rapidly? Is it agreed that we should not seek to eliminate the current account deficit through a lower exchange rate?
- (d) Is it agreed that, in order to maintain adequate downward pressure on inflation, we should take any opportunity that becomes available to tighten monetary policy without producing excessive upward pressure on the exchange rate?

18 January 1988