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CHANCELLOR

cc Chief Secretary
Financial Secretary
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Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Middleton
Mr Downey
Mr Hancock
Mr P Dixon
Mr Kemp
Mr H P Evans
Mr Cassell
Mrs Hedley-Miller
Mr Bottrill
Mrs Gilmore
Mr Peretz
Mr Turnbull
Mr Ridley
Mr Cropper
Mr Lankester (No. 10)
Mr Dicks-Mireaux (Bank)
Mr D Curran (FCO)
Mr Anson (Washington)
Mr Baker (Paris)

cc Prime Minister

Prime Minister

A foretaste of the OECD annual survey of the UK, which looks reasonably helpful (see conclusions at Flag A)

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OECD SURVEY OF THE UK: JULY 1981

This annual survey of the UK will not be published until 14 August, but copies have already been released to the press under embargo and it is possible (bearing in mind the unfortunate experience with the Economic Outlook last Christmas) that "leaks" may occur.

2. As you know, Mr Kemp, Mr Evans and I attended the OECD's annual examination of the UK in Paris during the last week in June. Following these meetings, and further exchanges with the OECD Secretariat, most of our difficulties with the text have been resolved. There remain a few areas (notably the detailed section on monetary policy and, to a lesser extent, the sections on inflation and fiscal policy) where we were unable to persuade the Secretariat to take all our suggestions on board. In the main, these differences of view affect the analysis of past trends and developments (eg in the monetary statistics) rather than the discussion of prospects or policies. And the press are likely to focus attention on the conclusions to the report (copy

attached at A), which were strengthened following our meetings in Paris and are fairly enthusiastic about the general thrust of UK policies. In particular, the conclusions:

- support the present stance of monetary and fiscal policy: "... the authorities will have to maintain a relatively tight and steady macro-economic policy stance over the medium term. This is in line with the agreement reached by OECD Ministers in June 1981 on the need for medium-term monetary and fiscal policies which are non-accomodating of inflation";

- stress the need to "improve competitiveness and raise profits, the latter entailing a substantial shift of real resources to the corporate sector". A lower exchange rate is not the answer to falling competitiveness which requires "a marked reduction of wage settlements coupled with rising productivity"; the report also argues for further use of fiscal policy to switch resources into the corporate sector;

- argue for achieving "a closer dialogue with the social partners not only on pay but in the whole area of working practices and economic performance generally";

- while the forecasts published with the report suggest "a modest recovery in activity is probable" in 1982, any lasting recovery "also depends on whether the improvement in productivity can be sustained and built on". This would require "further reductions in overmanning and restrictive business practices and on getting acceptance by the social partners of new and internationally competitive methods of work".

3. Slightly on the negative side, the report hints at inflexibility in UK policy - "changing circumstances may .... require adjustments ... to the policy strategy". In particular it would like to see the composition of public spending reconsidered "to create room for higher public investment of the type which would contribute to private sector productivity growth".

4. A section of the report deals with short term economic forecasts (see table attached at B). This assessment is very similar to that published in the July edition of the OECD's Economic Outlook. The forecast is broadly consistent with the FSBR, and lies around the centre of the range of major outside forecasts. There is some (½ per cent) growth in GDP in 1982, mainly built on a recovery in stockbuilding (Government consumption, fixed investment and net trade all continue falling). UK unemployment (including school leavers) rises to 13 per cent (over 3 million) by 1982 H2. Inflation (as measured by the 12 monthly increase in the consumer expenditure deflator) falls gently into single figures during the course of next year. It should be stressed, however, that the forecasts are based on an unchanged exchange rate assumption, taking as the starting point an average rate in April-May 1981. Since then there has of course been a further depreciation in the pound, which will have ramifications both for the inflation outlook and other aspects of the assessment. The document stresses (p. 45) that the forecasts are by the Secretariat; there is therefore no question of an endorsment by the Treasury or the UK Government.

Line to take

5. Ministers, while wanting to avoid being drawn into detailed comment, might welcome the general conclusions of the report. The following further points might be made:

a. Though the Treasury was consulted about the report at its various draft stages, and officials gave evidence to the EDRC during the annual examination on 29 June, the document is entirely the responsibility of the OECD's Economic and Development Review Committee, comprising representatives of all the member countries.

b. The report endorses the central policy aim of maintaining "medium term monetary and fiscal policies which are non-accomodating of inflation". Its conclusions are consistent with the Ottawa and OECD ministerial communiques, and the recent reports by the IMF and BIS.

c. It stresses the need for further moderation in pay settlements, and improved productivity, so as to reverse the decline in industrial competitiveness. Fiscal policy also has a role to play in channelling more resources to the corporate sector.

d. It encourages a "closer dialogue with the social partners".

e. The forecasts published with the report, which are the responsibility of the Secretariat and not the EDRC, see some recovery in output next year and declining inflation. They are broadly in line with the FSBR, and lie around the centre of the range of major outside forecasts.

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7 August 1981

surplus on invisibles in real terms is forecast to continue to decline. In total, the non-oil real foreign balance may impart a strong negative contribution to GDP growth during the forecast period (Table 16), but it will be dampened by an improvement in the real oil balance associated with a moderate but steady rise in North Sea oil production[68].

The forecast change in the real foreign balance largely explains the weak development of real GDP which after falling in the second half of this year should recover slowly through 1982. Although starting from a considerably lower level than real GDP, the recovery in manufacturing production is expected to be somewhat stronger, but by the end of the forecast period to be at a level of over one-fifth below the 1973 peak. The decline in GDP for nearly three consecutive years and its lagged effects on the labour market should lead to a further (albeit at a progressively slower rate) decline in employment. After the marked fall in productivity in 1980, a pick-up is expected from now onwards, particularly in manufacturing. The unemployment rate[69] could rise to about 13 per cent by the end of 1982 compared with about 11 per cent in mid-1981.

On the basis of a stable effective exchange rate, there should be a further small improvement in the terms of trade up to the end of 1982, but less so than was experienced up to the end of 1980. And in order not to worsen further the competitive position, profit margins in exports are likely to remain depressed. Under these conditions, the terms of trade improvement will be more than offset by the deterioration in the real foreign balance. There is also expected to be a further small increase in invisible payments associated with North Sea oil operations. Accordingly, the current account is forecast to move into small deficit by 1982, despite the growing slack expected over this period.

V CONCLUSIONS

A favourable feature of economic performance over the past year has been the marked reduction in inflation from a year-on-year rate of 22 per cent in the second quarter of 1980 to a rate of less than 12 per cent in the second quarter of this year. This improvement stemmed partly from the sizeable appreciation of sterling — which in turn reflected partly the commitment to the tight monetary strategy — and the related severe squeeze on profit margins. Since the autumn of 1980, the level of wage settlements has also substantially fallen reflecting both the deceleration in price rises and the increasing slack in the economy. Another encouraging feature has been the reported reduction in the private sector of overmanning, restrictive labour practices and other market rigidities which have hampered industrial performance in the past; so far, however, the effects of these changes on productivity have been masked by the cyclical decline in output.

Despite these favourable features of economic performance, however, the outlook for the next eighteen months — the period covered by the Secretariat's forecasts — remains difficult. On the fiscal and monetary policies discussed in

68 The contribution of North Sea oil to real GDP growth may be less than ¼ percentage point in both 1981 and 1982 compared with ¾ percentage point on average in the five years to 1980. Oil, as well as the other national account items, is valued at 1975 prices. On actual oil price levels the contribution from the rise in North Sea oil production will be around ½ per cent of GDP both in 1981 and 1982.

69 United Kingdom, including school leavers as a per cent of total employees.

Part III above and the exchange rate and other assumptions on which the forecasts are based, a modest recovery in activity is probable. Unemployment, nevertheless, seems likely to continue to rise though at a slower rate than in 1980 and business fixed investment to fall despite some inprovement in corporate profitability. Also, the current external account may move into deficit again; as destocking comes to an end, import volumes are expected to rise considerably while export volumes may continue to fall due to the weak growth of world trade and a loss of export market shares of around 20 per cent in 1981 and 1982 taken together. At the same time, further deceleration in the rate of inflation may be relatively small.

The authorities would thus seem to face a major dilemma of how to achieve a continuing reduction of inflation and renewed expansion of activity of sufficient strength to generate a recovery in productive investment and employment. Such a conflict is common in most Member countries but it would seem to be more marked in the United Kingdom than generally elsewhere, given the substantial loss of external competitiveness over the last two years and the depressed profit position in industry. Accordingly, it is necessary to improve competitiveness and raise profits, the latter entailing a substantial shift of real resources to the corporate sector. A lower exchange rate would help in these respects but it would have unfavourable effects on import prices and be inimical to progress in reducing inflation. The achievement of better competitiveness compatible with a rebuilding of profits and a further easing of inflationary pressures will therefore require a marked reduction of wage settlements coupled with rising productivity. Indeed, without a substantial change in both wage settlements and productivity, a worthwhile improvement in competitiveness would not — at current exchange rates — occur or at best be very protracted with important implications for exports, investment and employment.

The greater realism in private sector pay bargaining evident in the recent period is encouraging although the level of pay settlements has not yet come down enough to reverse the deterioration in unit labour cost competitiveness. The extent to which further pay moderation will take place is, however, uncertain; it remains to be seen whether pay determination practices have basically changed and inflationary expectations reduced. Moreover, over the past year, the deceleration in pay settlements was preceded by a slowdown of inflation — helped by the appreciation of sterling — so that real wages continued to rise. In fact, in the period ahead real wages will need to fall if the pressing need for a shift of resources to the corporate sector is to be realised. Over the last three years real average earnings and real personal disposable incomes have risen by 15½ and 17½ per cent respectively compared with a rise in real national disposable income of 7½ per cent, entailing a decline in profits[70] to their lowest post-war level; indeed, the major part of the benefits of North Sea oil has been reflected in consumption. Thus, while further moderation of pay settlements is essential to improve the performance of the economy, it may at the same time be more difficult to achieve. Accordingly, it would seem desirable to consider whether the requirement of reducing pay settlements could be enhanced by achieving a closer dialogue with the social partners not only on pay but in the whole area of working practices and economic performance generally.

In these circumstances, the authorities will have to maintain a relatively tight and steady macro-economic policy stance over the medium term. This is in line with the agreement reached by OECD Ministers in June 1981 on the need for medium-term monetary and fiscal policies which are non-accommodating of inflation. Changing circumstances may, however, require adjustments — as in

70 Real disposable incomes of companies outside the oil and financial sectors.

1980 — to the policy strategy. Subject to further progress in reducing inflation and depending on interest rate developments abroad there may be some further room for reduction of interest rates. Moreover, the efforts made to reduce the growth of public expenditure have fallen heavily on public investment which has declined sharply in recent years. A continuation of this trend could hamper the functioning of the economy over the medium term. Accordingly, it is important to reconsider the composition of public expenditure to create room for higher public investment of the type which would contribute to private sector productivity growth. It is desirable to ensure that the financial position of the public sector is brought into better balance and that the resources thereby released are used as far as possible to improve the financial position of enterprises in the non-oil, non-financial sector.

It was argued in Part II of this Survey that the expected recovery in output in 1982 should be reflected in a cyclical rise in productivity. The recovery of the economy also depends on whether the improvement in productivity can be sustained and built on. There is a large reserve of potential productivity gains in manufacturing and services as a result of the relatively high level of investment in plant and machinery in the past. This potential will have to be realised if worthwhile progress in reducing inflation and improving competitiveness is to be achieved and if there are not to be further business closures. The extent to which this will occur seems likely to be heavily dependent on further reductions in overmanning and restrictive business practices and on getting acceptance by the social partners of new and internationally competitive methods of work.

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during the forecast period but remain at a high level. To sum up, investment in manufacturing and distribution and services is forecast to be by the end of 1982 at about the 1978 level.

Table 16 The outlook for 1981 and 1982
Annual percentage change from previous period

	1980	1981	1982	1981 I	1981 II	1982 I	1982 II
Private consumption	¾	−½	¼	2	−3	1¼	1½
Government consumption	1¼	½	−¾	–	−¾	−1	−½
Fixed investment	−2¼	−7¾	−2	−10	−3½	−2¾	1
Public	−5¼	−11½	−2	−17	−1	−2	−2
Private	−½	−6¼	−2	−6½	−4½	−3	2½
Final domestic demand	½	−1½	−½	−½	−2¾	–	1
Stockbuilding[1]	−3	–	2	½	3	2	1½
Compromise adjustment[1]	−¼	−½	½	−1	1½	¼	–
Total domestic demand	−3	−2	2	−1¼	1½	2½	2½
Exports	½	−4½	¼	−4¼	−2	½	2
Imports	−3¼	−5	6	−4¾	6¼	6	6
Real foreign balance[1]	1	¼	−1¾	¼	−2¼	−1½	−1¼
GDP at market prices	−2	−2	½	−1	−¾	¾	1½
Real personal disposable income	2	−1½	−1	−3½	−2¼	−1½	1¼
Personal savings rate	15¼	14½	13½	14¼	14¾	13½	13½
Private consumption deflator	15½	11	9¼	11	11½	9	8¼
Employees in employment	−2¾	−4½	−1¼	−5	−2½	−1½	−1¼
Unemployment rate[2]	(7¼)	(11¼)	(12¼)	(10¾)	(12)	(12½)	(13)
Current balance of payments ($ US billion, annual rate)	6½	9¾	−¾	14	5½	½	−2¾

1 Change as a per cent of GDP in the previous period.
2 United Kingdom, including school leavers as a per cent of total employees.
Sources: Economic Trends; Press and Information Service Release, June 1981 and OECD estimates.

A small improvement in the earnings/house-price ratio since the spring of 1980, the fall in mortgage rates and a rise in the liquidity position of building societies point to a continuing recovery in private residential investment from the cyclical low around the turn of 1980. In addition, the forecast steep decline in local authority housing investment should also increase the private housing market, as is evident from a sharp rise in private sector housing starts and a sharp fall in public sector housing starts since early 1981. Despite the recovery, however, private residential investment at the end of 1982 is likely to be at a fairly low level by past standards[65]. In total, public and private fixed investment may fall by about 5½ and 8 per cent respectively in the two years to end-1982, thus making it the most contractionary component of domestic demand. Weak profits, positive real interest rates and the relatively high stock/output ratio at the end of 1980 point to further but slower destocking through 1981. This change, and moderate stockbuilding through 1982 should produce an important positive contribution of stockbuilding to GDP growth

65 Private residential investment at the end of 1982 is forecast to be below the level of each individual year between 1964 and 1979 and one-third below the peak in 1972.