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PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 7 December, are sidelined.

M M Deyes

M M DEYES

R.A

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14 December 1981

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires strict adherence to firm monetary and fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Place of 2 December announcements in economic strategy?

Decisions were taken within Government's broad priorities of: need to reduce inflation, control public expenditure, and pursue responsible financial policies.

3. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

4. MTFS no longer plausible?

Not so. Government remain determined to maintain downward pressure on monetary variables so as to keep up progress in reducing inflation. (Will need to judge appropriate fiscal stance in Budget.)

5. Expectations for next year disappointing?

[Industry Act Forecast, published 2 December: details at B2]

No. Further falls in inflation in prospect. A rise in output instead of a fall. Good export prospects and current balance will remain in surplus. Admittedly a gradual undramatic recovery, but UK operating in difficult economic environment. Prospects for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects: IAF broadly consistent with assumptions in Government Actuary Report that unemployment in 1982-83 will be 300,000 higher than in 1981-82. But if things go well - pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.]

6. Announcements reflationary/deflationary?

Neither. Announcements have to be seen in context of overall fiscal and monetary policies. On conventional assumptions set out in the IAF, figures point to a PSBR next year broadly in line with 1981 Budget projections. Further announcements only one half of picture. Cannot anticipate at this stage decisions on tax etc which fall to be taken at Budget time.

7. Effect of higher NIC, rent, health charges, on wages? inflation?

[Announcements increase RPI by 0.6 per cent (mainly higher council rents) and TPI by 1½-2 per cent (reflecting also higher NICs) from next April.]

Growing evidence of greater realism in pay bargaining. Pay bargainers unlikely to look at NIC and other changes in isolation from circumstances of their own industry - as well as wider economic factors. Prospects for inflation depend on developments in pay, import prices, interest rates and the financial position of companies. These all taken into account in IAF.

8. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also E2-3 and 17.]

9. Tax increases necessary?

Cannot foreshadow Budget. Undoubtedly, higher public spending makes prospects for PSBR, interest rates and burden of taxation next year more difficult. But, as rhF said in his 2 December statement, on conventional assumptions figures point to a PSBR next year broadly in line with projections published at time of Budget. Final assessment must await Budget next year. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

10. Distributional effects of 2 December statement

NIC increases will take a larger proportion of net income from the better paid, up to the earnings limit. Council rent increases will not be flat-rate because of rebate system: lower-paid get more rebate. Pensions and unemployment and other benefits are planned to increase by more than the expected rise in earnings, implying a redistribution from the working population to the unemployed and elderly.

11. Government has failed to allow accommodation to the recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to "buy" jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

12. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth of money GDP fallen sharply. Inflation rate halved. Some good features in monetary picture -outturn for PSBR in 1981-82 should be close to forecast; funding programme on track. [Nevertheless, bank lending disturbingly high, particularly personal lending.]

13. Why are high interest rates needed?

Current level of interest rates has reflected developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1½ per cent since September.

14. Government should change course?

(a) Moderate reflation the answer?

[Alternative reflationary packages continue to proliferate: eg NIESR suggested £5 billion in their November Review; £6.8 billion reflationary package proposed by Hopkin/Miller/Reddaway]

Government recognise need to respond flexibility to economic situation, within framework of overall strategy. But no question of abandoning that strategy. Cannot throw away gains made so far by return to discredited policies. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing resurgence of inflation and undermining financial markets, and, as a consequence, interest rates rising further and faster. Even large reflationary packages yield relatively small benefits eg NIESR £ 5 billion package would reduce unemployment by only 150 - 300, 000 after 5 years.

(b) Reintroduce exchange controls and join EMS?

EMS is not a panacea. But Government does fully support EMS as an important step in monetary co-operation and closer integration in the European Community. Have stated that UK will participate in the EMS exchange rate mechanism when conditions appropriate both for the system and ourselves. Question is kept under constant review.

(c) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Is recession over?

The fall in output now over. GDP output rising - preliminary figures for Q3 up ¼ per cent on Q2. Manufacturing and construction output increased by 2 per cent and 2½ per cent respectively in same period. Q3 figures for manufacturers' and distributors' stocks show rate of destocking reduced by about two-thirds compared with H1 1981. October industrial production figures continue to show improvement - manufacturing output up 2¾ per cent from low point (H1 1981). New Industry Act forecast sees continuation of recovery in output.

IF ASKED about decline in CSO's longer leading indicator: Too early to judge significance; recall that temporary weakening occurred in last cycle.

[NOTE: November cyclical indicators to be released 17 December. DOI Investment Intentions survey due out also 17 December.]

2. Government assessment of prospects

[New Industry Act forecast (2 December) assessed recovery to have begun.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

End to destocking. Consumers' expenditure and Government expenditure flat.]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

3. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	1/3	1	
CBI (Nov)	0	2/3	
Phillips & Drew (Dec)	0	¾	
OECD (July)	-1/3	0	
(IAF - for comparison)	½	1	

November NIESR Review contains only annual data, but commentary suggests low point reached in H1 1981, with prospect of some recovery.]

Recent major independent forecasts assess that low point in activity was reached in first half of year, with prospect of some recovery in the coming year.

4. Higher interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitabilityand competitiveness.

5. Recession worse than in the 1930s?

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[November total count was 2,954,000 (12.2 per cent) - second consecutive month showing slight decrease. Seasonally adjusted excluding school leavers figure was 2,764,000 (11.4 per cent)]

Unemployment rising much less rapidly. Increase in recent months less than half those at end of last year [44,000 per month in 3 months to November 1981 compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut -(down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised and now show signs of some pick up. Vacancies improving too.

2. Employment continues to fall?

[Total employment fell further ¼ million in Q2 1981, much the same as in Q1. Total decline since mid-1979 1.7 million or 7½ per cent.]

Decline in manufacturing employment showing signs of further marked slackening in August and September (25,000 compared with about 50,000 per month earlier in year), and 80,000 per month in H2 1980.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED on whether unemployment will "peak next year". [Headline to report in The Times 8 December of Mr T Burn's evidence to TCSC.] Mr Burns referred to unemployment assumption given to Government Actuary; said it was not far from Treasury assessments, GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in range especially for beyond next year.

5. Unemployment higher than in other countries?

[OECD standardised data show UK Q1 1981 at 10¼ per cent compared with OECD average of 6¼ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment; (figure of £450 million estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. Treasury's internal revision of figure published in February Economic Progress Report not published so far - further article likely in EPR in near future.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed. As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

7. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

8. Should spend more, especially for young people?

Next year, Government is planning to spend £2.7 billion on employment programme, special employment and training measures. Of this, £0.8 million on YOP and other programmes for young people. In addition, estimated expenditure on redundancy payments has risen by £135 million. The total also includes provision for the further training measures to be announced by the Secretary of State for Employment.

9. Need to improve training at all levels?

Agree. Aim must be both to help individual and strengthen economy by having a better trained workforce. Government has fully endorsed objectives of MSC's New Training Initiative. We shall be making a statement before the turn of the year about role which Government and others can play.

10. Unemployment as bad as in the 1930s?

Comparisons extremely difficult to make. Maximum recorded unemployment in 1930s was just under 3 million; but the labour force has grown by about $^1/_3$ since, so unemployment rates in the 1930s almost certainly higher than now. One also needs to bear in mind changed social conditions and protection given by the welfare state.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 35 per cent of GDP (at market prices), 36½ per cent in 1979-80, 38 per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government. Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax].

2. What are implications of 2 December announcements for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in his statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. Other factors will also be important, including monetary targets and outlook for pay and inflation.

3. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

4. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be greatest help. But could not prejudge Budget judgment both on whether could afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load increase in National Insurance contribution on to employees.

5. NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

6. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

7. Revenue shortfall in alcohol and tobacco duties due to Budget increases?

[Stockbrokers' comments widely reported 1 December. Detailed briefing was provided to PM 2 December.]

Revenue estimates complex, and open to wide margin of error under normal statistical conventions, given that yield from duties is over £6000 million. Outsiders' estimates contain internal inconsistencies. Budget increases did no more than restore real value of duties to mid-1970's position - when allowance made for inflation.

8. Progress with examining corporation tax structure?

[Promise to re-examine corporation tax structure in 1980 Budget Speech]

It is hoped to produce the Green Paper on corporation tax this winter.

9. Progress so far on tax reform/simplification?

[As in CST's speech 18 November]

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

10. North Sea fiscal regime?

See R3.

E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced main decisions for public spending 1982-83 on 2 December. Main increases on programmes are for local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for the nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash limited expenditure and by specific cuts - including increases in prescription charge and other health charges. Planning total for next year will be in the region of £115 billion against £110 billion for the White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in the White Paper to be published at the time of the Budget.

2. 1981-82: Overspending?

[Outturn for the current year is expected to be in the region of £107 billion against £104½ billion in the last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. The major reason for this is the present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring, and changes in circumstances could well lead to a higher or lower total than the £107 billion we now provisionally expect.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Are plans for 1982-83 reflationary or deflationary?

As my rhF the Chief Secretary said during the debate on 8 December, the changes are neither reflationary or deflationary.

5. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

6. Failure to cut spending?

Our decisions to increase spending next year reflect a flexible but prudent response to changed circumstances. The increases we have decided were however offset in part by reductions elsewhere.

7. Implications for tax and monetary policy?

A matter for the Budget. But a high level of spending does mean taxation higher than it would otherwise be. The alternative would be more borrowing and higher inflation and interest rates.

8. Increase spending during recession?

It is not the Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within the limits of prudence, to the needs of current circumstances.

9. Increase spending on worthwhile infrastructure projects?

Our first concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But as my rhF the Chief Secretary said during the debate on 8 December, social security spending is the only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

10. Public capital investment in 1982-83 cut by £500 million compared with 1981-82?

[Claimed by The Times in leader by 8 December.]

As my rhF the Chief Secretary said during the debate on 8 December the figure mentioned in The Times is not accurate. As far as the nationalised industries are concerned, so long as they restrain their current costs the extra cash provision we have given them should allow them to maintain their investment next year at broadly the same level in real terms as this year - and that is in real terms 15 per cent up on the 1980-81 level. Other public capital expenditure will be a little lower in cash next year compared with this but keen tendering will mean the programmes should be carried out as planned.

11. Number of cash limits breached last year?

In aggregate, central government voted cash limits in 1980-81 were underspent by just over 1 per cent. There were 6 individual breaches of cash limits (4 on central government and 2 on local authorities) compared with 13 in 1979-80, and amounts involved were marginal. A full statement of provisional outturn of spending compared with cash limits in 1980-81 was published as a White Paper (Cmnd 8437) on 4 December.

12. Position on 1981-82 cash limits?

Provisional outturn figures for first half year were published with Winter Supplementary Estimates in Financial Secretary to the Treasury's note on 4 December. Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases the excess is due to a shift on timing of expenditure and/or receipts; in other cases there have been cash limit increases. In remaining cases position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

13. Cut public sector pay bill?

We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector. Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on.

14. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is the smallest for over 14 years and we are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 70,000 (over 3 per cent).

15. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

16. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

The ratios in 1980-81 (44½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46½ per cent in both years). The large rise from 41½ per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen.

LOCAL GOVERNMENT

17. Spending plans for 1982-83? Too tough? Too weak?

We have accepted that it will not be practicable for local authorities to eliminate all their present overspending in a single year. We have therefore increased plans by £1.35 billion. As a result targets will be both reasonable and realistic. But this does not mean we have conceded defeat. Substantial economies will still be required as plans allow only about 2 per cent more cash spending than latest budgets for this year. Pressure to curb overspending through RSG system and otherwise will be maintained.

18. Cut in RSG percentage will mean large rate increases?

Not at all. Must look at combined effect of increase of £1.35 million in plans and RSG percentage. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend. [IF PRESSED for a figure: Predictions of average rate increases are very unwise as any average figure rapidly becomes a minimum. Impossible to give a meaningful figure because of enormous variation in local authorities' spending intentions.]

19. Increased burden on industry?

Very conscious of harmful effect of large rate increases. But remedy lies with local authorities. Realism of Government's plans means that there is no need for high rate increases.

20. Scotland and Wales?

Plans have also been increased. Rate increases will be very moderate if local authorities budget in line with Government's plans.

21. Rates: alternatives?

[A Green Paper on alternatives to domestic rates is expected to be published on Wednesday 16 December. New proposals to prevent supplementary rates may also be announced the same day. FT 14 December offers preview of contents of Green Paper.]

We shall be publishing a Green Paper later this week.

F SOCIAL SECURITY

[Note: 2nd Reading of Social Security Bill on 16 December]

1. Increase in employees' national insurance contributions?

[Chancellor and Social Services Secretary announced on 2 December 1 per cent increase in employees' national insurance contribution from 7.75 per cent to 8.75 per cent to be made from April 1982, as part of review of National Insurance Contributions. Increase will help increase TPI from April - J4. Bill to implement this published on Thursday 3 December].

An increase in contributions was necessary to pay for increased benefit expenditure (notably retirement pensions), increased redundancy payments and to maintain expenditure on the health service. Relative share of these costs met by employers has increased in recent years; we consided it essential to avoid placing this additional burden on them. Employers will still be bearing a higher proportion of the burden than they did ten years ago.

2. What about Treasury Supplement?

[Bill also provides for a 1½ per cent reduction in the Treasury Supplement - from 14.5 per cent to 13 per cent].

Treasury Supplement represents only one part of cost of benefit expenditure met by the general taxpayer. If all such expenditure taken into account, general taxpayer still be funding as high a proportion of benefit expenditure next year as this year - and substantially more than a few years ago. Not, therefore, unreasonable for contributors, rather than general taxpayer, to meet these extra costs.

3. Burden on employers?

We have avoided making any increase in employers' rate of contributions. Some increase in cash burden is, however, inevitable simply because of higher earnings. In addition, pper arnings limit has been raised by £20 to £220 - which adds a relatively small additional cash burden. Cash payments to increase by around 7 per cent, that is, slightly less than our estimate of the movement between 1981-82 and 1982-83 in earnings (7.5 per cent) and substantially less than the movement in prices (10 per cent).

4. Balance on the Fund?

We are budgeting for a very small deficit (£9 million) this year. The accumulated balance in the National Insurance Fund is of order of £5 billion. This may seem large as a proportion of expenditure; it has, however, been falling, and now represents about 13 weeks benefit expenditure - as compared with 25 to 30 weeks ten years ago. A balance of some weeks expenditure is necessary to cope with emergencies such as flu epidemics and industrial disputes.

5. Restoration of shortfall on unemployment benefit, etc?

As my rhF the Chief Secretary said in the House last Tuesday, the decision on the level of benefits in November 1982 is announced at the time of the Budget, when account can be taken of the latest forecast of price inflation. In reaching our decision we shall of course take into account everything hon Members said during the debate last Tuesday. They will no doubt continue to give their views.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast published 2 December shows PSBR in 1981-82 was £10.2 billion; PSBR in April - September was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR?/Revenue still outstanding?

[CGBR April-November was £9.4 billion.]

The shortfall of net revenue outstanding at the end of November from the start of the dispute was about £4 billion, of which around £3 billion related to the current financial year. Interest costs so far on the additional borrowing caused by the dispute are around £350 to 400 million.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Public expenditure likely to overrun this year?

[On 2 December, Chancellor referred to £107 billion - £2 billion above Budget time plans.]

It is too early to be certain what the outturn for the current year will be. The local authorities are, admittedly, spending above the Government's plans. We are taking measures to deal with that but these measures cannot be effective this year. Expenditure which is under the Government's direct control is running broadly according to plan in total.

5. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

6. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

H MONETARY AND FINANCIAL POLICY

1. Why has Bank of England appeared to brake the fall in UK interest rates when rates overseas, particularly in US, have fallen rapidly?

[US 1-month rates have fallen about 5½ per cent over past two months, but have firmed slightly in past few days; UK rates fell by 2 per cent over same period.]

Of course we want to see lower rates. But must proceed cautiously if we are not to let up in the fight against inflation. Clearing banks have already reduced base rates by 1½ per cent from their peak. But wrong to think that rates could safely drop much further in near future without potentially dangerous consequences for inflation.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that higher interest rates will increase difficulties of industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

5. Will there be an overshoot of money supply?

[£M3 increased by ½ per cent in banking November, bringing recorded increase in first nine months of target period to 13 per cent. Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high, particularly personal lending.

6. <u>When will the strike distortions be eliminated?</u>

Distortion will continue for some months yet. The distortion to the CGBR was reduced by over £1 billion in (calendar) November. In eight months ending November the effect of strike was to add around £3½ billion to the CGBR.

7. <u>Status of MTFS if money supply overshoots for second year running?</u>

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregate.

8. <u>But increase in bank lending not inflationary: house prices stagnant, retail sales flat or falling?</u>

Very hard to distinguish upward pressure on prices due to bank lending from downward pressure due to other factors, especially falling real personal disposable incomes. Effect of higher bank lending will not be felt on prices immediately, but only with a lag.

9. <u>Ceilings on non-priority bank lending?</u>

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 11.7 per cent in October.

2. Inflation back on a rising trend?

[Year-on year rate of inflation rose to 11.7 per cent in October compared with 11.4 per cent in September and lowest recent level of 10.9 per cent in July. Effect of mortgage interest increases estimated at around ½ per cent on RPI in November, some 2/3 per cent in December.]

Progress on inflation has been affected by the fall in the exchange rate, and the rise in the mortgage interest rate will affect the RPI. We expect further progress in reducing inflation, but the timing is of necessity uncertain.

3. Industry Act forecast (12 per cent by Q4 1981; 10 per cent Q4 1982)

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Government is confident that downward trend in inflation will be resumed.

4. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

5. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI.

6. TPI

The fact that the TPI has been increasing faster than the RPI (3½ per cent faster over the year to October) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

7. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

8. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be more; some less. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurance they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

9. Public sector ignoring 4 per cent policy?

[Firemen have now settled at 10.1 per cent; NUM have rejected revised offer worth 9.3 per cent on basic rates [NOT FOR QUOTATION: 7.4 per cent on earnings]; water manuals considering offer worth 8.8 per cent on earnings; LA manuals considering offer reported as worth 6.3-7.8 per cent on basic rates]

Pay negotiations in local government and the nationalised industries are a matter for the parties concerned, as are the financial consequences of any settlements reached. The Government has continually stressed importance of restraining current costs, including unit labour costs.
[NOTE: Not enough settlements yet in this pay round in private sector to comment on trend there]

10. Government aiming to cut living standards?

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

11. Average earnings index

[Drop in year on year growth from 12.8 per cent in August to 9.4 per cent in September may attract attention, though (unpublished) underlying increase unchanged at 11 per cent]

I very much welcome the sharp reduction in pay settlements which has been achieved over the past year. Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

12. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

13. Layard's wage inflation tax?

Like any other attempt to rely on incomes policy, Layard's proposal (picked up by SDP) would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

14. Index-linked pensions and the Scott Report?

We are considering question of index-linking of public service and other public sector pensions, including the question of contributions made by public servants for their pensions. Changes in these arrangements could produce further savings in due course.

K BALANCE OF PAYMENTS

1. Balance of payments in third quarter 1981

[Figures for invisibles and capital transactions published 9 December]

The capital account outflow in Q3 was much smaller than earlier in the year. Portfolio investment abroad (estimated at £1.3 billion in Q1) was only £0.6 billion in Q3. Total surplus on invisibles was £303 million.

2. What is happening to the trade account?

November figures are not yet available. September and October trade figures show a small surplus; this is probably the best guide.

3. Trade figures for October

The October figures show that the current account continues in surplus. Exports have performed much better than many people expected and held up well. Imports have recovered from the depressed level at the start of 1981. This is consistent with a slowdown in destocking and recovery in output.

4. Trends in exports

Export figures for September/October very uncertain: but appear to have held up well under difficult circumstances, despite sluggish world trade and earlier losses of competitiveness. Export orders for British engineering industries show a 40 per cent increase since the summer.

5. Trends in imports

The increase in import volumes in October confirms recent evidence of slowdown in destocking, and recovery in output. Import volumes are 16 per cent higher than in the first four months of 1981 but are only 1 per cent higher than in 1980.

6. Trends in invisibles

Invisible earnings continue in substantial surplus and are likely to rise to about £200 million a month in the fourth quarter of 1981 due to budget refunds from the EC.

7. Capital flows

The net capital outflow in 1981 Q3 was about £0.7 billion compared with £1.9 billion in 1981 Q2. These capital flows represent overseas investment which will provide a valuable source of overseas income in future years. There is no evidence that outflows deprive UK firms of capital to invest.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since July sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 11 December were $1.8810; DM4.241 and an effective rate of 89.69. Reserves at end November stood at $23.5 billion, compared with $23.2 billion at end October]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor told the TCSC in July 1980, it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends That continues to be the Governments' view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M13]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of perhaps 10 per cent so far this year. This is partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. By end of 1981, total official external debt will be reduced to around $14 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

[Note: Meeting of Finance Council scheduled for 14 December business to discuss draft annual Community report.]

MEMBERSHIP OF EUROPEAN COMMUNITY

1. Follow-up to European Council?

Further work concentrating on four issues - problems arising from Community milk surplus; support measures for Mediterranean agriculture; limiting spending on agriculture; and the Budget problem. Foreign Ministers to meet and report back to Heads of Government.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May last year.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We are examining the new Commission estimates. If our adjusted net contribution in respect of 1980 and 1981 turns out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

1. Recent increases in interest rates - damaging for industry and investment?

(Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.)

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Encouraging evidence that fall in output has now come to an end. Too early to talk about recovery: but index of manufacturing output rose 1½ per cent in the third quarter with chemicals and engineering performing particularly well.

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £3¾ billion in Q2 1981 for third successive quarter. Borrowing requirement of ICCs has improved over last year, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

4. Industries' claim that 2 December package adds £600 million to employers' costs?

[Higher NIC £200 million; higher rates £400 million.]

In real terms burden of NIC/NIS on employer's likely to fall in 1982-83, for second year in succession. And company sector now in rather stronger financial position than a year ago, partly through Government policies to switch fiscal burden.

SMALL FIRMS

5. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

6. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued more than 1500 guarantees - well over half to new businesses. Total lending under scheme is already over £52 million. Substantial demand for loans has led the Government to double this year's lending limit under the scheme. Ten new banks were admitted to the Scheme in November: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early next year.

8. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Why not give British Telecom more?

The £340 million EFL is still relatively large, particularly for a profitable industry. Ministers will be looking to British Telecom, as to others, to make a substantial contribution through reduced costs. There could be a higher figure if the bond proves feasible.

5. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

6. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published in August estimated in range of £250-500 million this year.

7. Future years?

Investment approvals for the years 1982-83, 1983-84 and 1984-85 have yet to be settled. They will be communicated to the industries in due course and will be published in the forthcoming Public Expenditure White Paper.

8. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries should be able, in total, to maintain broadly the same level of investment in 1982-83 as planned in the last White Paper, despite lower revenue, with higher investment in important industrial priorities, eg telecommunications. This will enable the 15 per cent real increase over the 1980-81 level, which was included in the 1981-82 plans to be sustained. These plans, in turn, represented the highest real level of investment in the industries since 1975-76.

9. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

10. Private finance for NI investment?

(The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

11. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

12. ·But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £[redacted] 125 million per annum; and each 1 per cent off total costs saves £[redacted] 300 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

13. Nationalised industries' prices have risen more rapidly than RPI?

True over last year or so, while adjustments from artificial and distortionary price restraints introduced by the Labour Government were working through the system. Unwelcome but inevitable: the only alternative is an increased burden on the taxpayer and a distortion of market forces.

14. What is happening now?

Nationalised industry price increases are falling relative to the RPI (14 per cent above in year to January, 3 per cent above in year to October). Fully expect them to come closer to RPI in next few months.

15. And the future?

Better price performance depends on improvements in efficiency and control of current costs, particularly pay. We are determined to see those improvements brought about. Privatisation and increasing competition have an especially important role here.

PRIVATISATION

16. The Government simply selling valuable national assets to achieve PSBR target?

Of course, the cash is welcome, but the benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. We shall be announcing further measures in due course.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. Will HMG change North Sea fiscal regime in line with oil industry's proposals?

[Memoranda lodged with Treasury and D/Energy 22 October].

Recommend UKOOA (UK Offshore Operations Association) and BRINDEX for the hard work which they have put in. Obviously full study of their proposals is required. We shall look at their suggestions with an open mind, in close liaison with UKOOA and BRINDEX.

3. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

4. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

5. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special fund would make no difference. More money would not magically become available. So the money for this special fund would have to come from somewhere else - lower public expenditure, higher taxes or higher public borrowing.

6. North Sea oil bond?

Ministers concerned are currently finalising a decision on this.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Output in OECD area grew modestly in first half 1981. Little information on Q3; but small rise in US and French GNP. Industrial production picture in Q3 mixed. Average unemployment rate rising.] [OECD believe output of member countries will have stayed flat in second half of this year, and will recover gradually in 1982. CONFIDENTIAL: NOT FOR USE This OECD forecast not yet published.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected next year. And unemployment should level off during the year.

2. OECD gloomier about world economic prospects?

[Draft report referred to in Sunday Times 15 November]

Latest OECD forecast is still being prepared. Most major forecasts, including the IMF's, expect modest growth next year. OECD forecasts unlikely to be markedly different.

3. Comment on latest NIESR Review forecast for industrial countries?

[Report published 26 November forecasts 'slow' economic growth and 'gradual' decline in inflation in industrial countries in 1982 and 1983.]

Interested to note that NIESR forecasts lower inflation and rising output in the industrial countries in next few years.

4. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries around 10 per cent in September. Underlying rates increasing in US and France. OECD and IMF expect some decline next year.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 10 per cent in September 1981. Further decline expected next year.

5. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

6. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

7. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

8. Other governments not following such stern policies as UK?

[US, Canada and Germany have announced lower monetary targets for this year compared with last. Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Recent Canadian Budget will reduce deficit.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

9. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

10. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

11. Recent comments by US Budget Director have undermined confidence?

[Press reports of Dr Stockman's description of Budget spending cuts as "hastily prepared and enacted" and tax cuts "Trojan horse" favouring the rich, while casting doubt on "Supply side" policies].

I note that Dr Stockman has apologised for his "careless ramblings to a reporter".

12. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to 16 per cent from peak of 21½ per cent; also German rates declining.

13. <u>Prospects for international interest rates?</u>

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 14 December 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, Industry Act Forecast (IAF)) assess recession's trough was reached in H1 1981, with some recovery in year to H2 1982 (in range ½-2¼ per cent). Item are more pessimistic , seeing output fall a further 2 per cent in 1982, recovery thereafter. Unemployment (UK adult sa) forecast to increase to around 3 million by end 1982. (IAF does not assess unemployment prospects). Most major forecasters see year-on-year inflation in range 11-12½ per cent for Q4 1981, falling to 9-11 per cent in Q4 1982. Item and St James are more pessimistic; forecasting range of 13-15 per cent. Item see a sharp drop, well into single figures in 1983. The IAF which sees inflation falling to 10 per cent in 1982 Q4, lies at the centre of the range.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In the 3 months to October 1981 industrial output and manufacturing output both rose 1½ per cent.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales in the 3 months to November 1981 were unchanged. In September and October the Volume of visible exports was 4 per cent above the average in January and February. Volume of visible imports rose 21 per cent on the same comparison. Manufacturing investment (excluding assets leased from the service sector) fell 4½ per cent in Q3 1981. Distributive and service industry investment (including shipping and leasing) was virtually unchanged in Q3 1981. DI investment intentions survey (conducted in April/May) suggests a fall in manufacturing investment after allowing for leasing of 11 to 14 per cent in 1981 with some recovery in 1982; distributive and service industries investment (including shipping) expected to rise by less than 5 per cent in both 1981 and 1982. Manufacturers', wholesalers' and retail stocks dropped by £0.2 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl. school-leavers) was 2,764,000 (11.4 per cent) at November count, up 36,000 on October. Vacancies rose slightly to 104,000 in November.

Wholesale input prices (fuel and materials) fell ½ per cent in November; the year on year increase fell to 16½ per cent. Wholesale output prices rose ½ per cent and remain 11 per cent above a year ago. Year-on-year RPI increase was 11.7 per cent in October. Year-on-year increase in average earnings was 9.4 per cent in September. RPDI fell by 2½ per cent in Q2 1981 after a 1½ per cent fall in the previous quarter and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio fell 2 per cent to 12½ per cent in Q2 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to November - £9.4 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by ½ per cent in banking November.

Visible trade showed an estimated surplus of £13 million in September and £116 million in October compared with an average monthly surplus of £368 million over the period July 1980 to February 1981. Invisibles surplus in first ten months of 1981 estimated at £2.4 billion. Reserves at end-November $23.5 bn. At the close on 11 December the sterling exchange rate was $1.8805 and the effective rate was 89.8.